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THE GREAT UNKNOWN: WHAT REALLY HAPPENS WHEN PARTNERS DIE?

By

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I. TRANSFERS AT THE DEATH OF A PARTNER

A. Initial Considerations and Critical Concepts

1. It's been said that the only certainties in life are death and taxes. If that is the case, then it is surprising that so little has been written, in depth, about what happens when an individual partner dies owning an interest in a partnership. Partnership tax treatises typically devote a few paragraphs to the subject, but they don't go into great detail about all of the intricate tax ramifications that the death of a partner can have to the successors in interest who receive the partnership interest, the partnership, and the remaining partners. In addition, many treatises do not discuss deemed transfers of partnership interests that occur when intentionally defective grantor trusts[1] (IDGTs) become taxable non-grantor trusts upon the death of the grantor. These materials attempt to close that information gap.

2. When a partner dies, for income tax purposes, there is a transfer (actual or deemed) of the decedent's partnership interest to another taxpayer. That transfer can take a number of different forms. For example, the transfer could be from:

a. The decedent to his or her estate;

b. The decedent's revocable trust to the same trust, which is now a taxable non-grantor trust;

c. An IDGT to the same trust which is now a taxable non-grantor trust; or

d. The decedent to an immediate successor in interest that has been designated under the partnership agreement.[2]

Some of these partnership interest transfers will be subject to a basis adjustment at death under section 1014, while other transfers will not. Furthermore, some of these transfers may be considered recognition events, triggering gain to the transferring partner upon death.

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[1] Trusts that are grantor trusts under section 671, but the assets in the trust are not includible in the gross estate of grantor for transfer tax purposes when the grantor dies. *See, e.g.,* Stuart M. Horwitz & Jason S. Damicone, *Creative Uses of Intentionally Defective Irrevocable Trusts*, 35 Est. Plan. 35 (2008) and Michael D. Mulligan, *Sale to Defective Grantor Trusts: An Alternative to a GRAT*, 23 Est. Plan. 3 (1996).

[2] *See, e.g.,* Treas. Reg. § 1.706-1(c)(2)(iii) which was removed in 2015. 80 Fed. Reg. 45865 Prior to its removal, it provided, in part, "If a partner (or a retiring partner), in accordance with the terms of the partnership agreement, designates a person to succeed to his interest in the partnership after his death, such designated person shall be regarded as a successor in interest of the deceased for purposes of this chapter."

3. For purposes of these materials, the term "partnership" includes any non-corporate business entity that is treated as a partnership for Federal income tax purposes, but there is some discussion of disregarded entities.[3] As such, the term "partner" also includes a member of a limited liability company. The discussion in these materials is also limited to "family limited partnerships," partnerships that are wholly or primarily owned by related parties. That is also why, unless indicated otherwise in these materials, it is assumed the partnerships discussed herein are structured as "pro rata" or single class share partnerships where all allocations of tax items and distributions are made according to each partner's percentage interest in the partnership (typically tied to relative capital account balances).

4. Ownership in family limited partnerships is typically "pro rata" in order to avoid transfer tax complications under Chapter 14 of the Code, with most practitioners relying on the "same class" exception under section 2701(a)(2)(B). With the respect to this exception, the Treasury Regulations provides, "[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability)."[4] In order to qualify for this exception, it generally requires that distributions be made proportionately and at the same time (but not necessarily the same assets). By consequence, to effectuate a disproportionate distribution of property to a partner, one would need to redeem a portion of the partner's interest (reduce percentage ownership) in a current distribution or liquidate the partner's interest.

5. A good portion of these materials involve partnership basis adjustments and certain transactions that can "shift" the basis from one asset to another. On June 17, 2024, the IRS issued three different types of guidance dealing with basis adjustment and shifting transaction between related parties. The were: (i) Revenue Ruling 2024-14 (Clarification of Economic Substance Doctrine);[5] (ii) a notice of proposed rulemaking (proposed regulation section 1.6011-18) relating to "Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of Interest;"[6] and (iii) Notice 2024-54 announcing "Forthcoming Guidance Regarding Certain Partnership Related-Party Transactions."[7] As discussed below, it appears that only Revenue Ruling 2024-14 will remain in effect. Although Revenue Ruling 2024-14 has immediate effect on taxpayers, it may have the least relevance and impact on family-owned partnerships

[3] Under the Internal Revenue Code of 1986, as amended (hereinafter, the "Code" and all references to a "section" or denoted with "§" will refer to a section of the Code, unless otherwise noted), an unincorporated business entity (e.g., limited liability company, limited partnership, or general partnership) with two or more partners or members is classified for federal tax purposes as either a corporation or a partnership. An unincorporated business entity with only one owner is classified as a corporation or a disregarded entity. *See* Treas. Reg. § 301.7701-2(a). For domestic unincorporated business entities, the default classification for an entity with two or more partners or members is a partnership, and for an entity with one owner, it is a disregarded entity. *See* Treas. Reg. § 301.7701-3(a). Thus, unless the unincorporated entity elects to be taxed as a corporation, a domestic eligible entity is a partnership, if it has two or more owners, or is a disregarded entity, if it has (or deemed to have) a single owner. *See* Treas. Reg. § 301.7701-3(b). As such, just because an entity is, under state law, a partnership (general or limited) or a limited liability company, it may not be classified as a partnership or a disregarded entity for Federal tax purposes.

[4] Treas. Reg. § 25.2701-1(c)(3).

[5] Rev. Rul. 2024-14, 2024-28 I.R.B. 18.

[6] REG-124593-23, 2024-28 I.R.B. 40.

[7] Notice 2024-54 2024-28 I.R.B. 24.

and related parties affiliated with or owning an interest in a partnership.[8] Notice 2024-54 was simply an announcement of the Treasury Department's intent to publish, at some future time, proposed regulations addressing basis shifting transactions involving partnerships and related parties. Although, as described in the Notice 2024-54, if issued, the proposed regulation would have dramatically changed the tax treatment of basis shifting transactions. The validity of these rules likely would have been challenged because there is no Code provision authorizing these changes, in light of the U.S. Supreme Court ruling in *Loper Bright Enterprises v. Raimondo*[9] (overturning *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc*., which required courts to defer to a Federal agency's reasonable interpretation of ambiguous statutes).[10]

6. On January 14, 2025 (the effective date),[11] the IRS issued final Treasury Regulation section 1.6011-18, making certain related-party basis adjustment transactions as transactions of interest ("TOI"), imposing certain disclosure and record-keeping requirements on clients and materials advisors. Subsequently, on April 17, 2025, the IRS released Notice 2025-23,[12] announcing that the Treasury Department and IRS intend to publish a notice proposed of proposed rulemaking (the "NPRM') to remove the foregoing final regulations (along with a waiver of associated penalties).[13] Notice 2025-23 also immediately withdraws Notice 2024-54, mentioned above. The NPRM will have a proposed effective date of April 17, 2025, and it states that taxpayers and material advisors can rely on Notice 2025-23 until the NPRM is finalized.

7. Until the NPRM is finalized, some discussion of section 1.6011-18 of the Treasury Regulations is warranted. In addition, the final Treasury Regulations also provide insight on the types of basis shifting transactions that were of particular concern to the IRS and the Treasury Department. The preamble to the final Treasury Regulations label these TOIs according to the operative Code section, as follows:

a. Section 734(b) TOI:[14] A current or liquidating distribution of property (including cash) to a related partner, and the partnership increases the basis of one or more of its remaining properties under section 734(b) and (c). ***Distribution of High Inside Basis Property to a Low Outside Basis Partner-Section 754 Election in Effect.***

b. Section 732(b) TOI: [15] Liquidating distribution of property to a related partner, and the basis of the distributed property is increased under section 732(b) and (c). ***Distribution of Low Inside Basis Property to High Outside Basis Partner.***

[8] The Code provides an exception to the application of the economic substance doctrine to "personal transactions of individuals" and "shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income." § 7701(o)(5)(B).

[9] *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024).

[10] *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984),

[11] T.D. 10028, 90 Fed. Reg. 2958.

[12] Notice 2025-23, 2025-19 I.R.B. 1428.

[13] Notice 2025-23 and the NPRM are issued pursuant to Executive Order 14219, *Ensuring Lawful Governance and Implementing the President's "Department of Government Efficiency" Deregulatory Initiative* (February 19, 2025).

[14] Treas. Reg. § 1.6011-18(c)(1)(i).

[15] Treas. Reg. § 1.6011-18(c)(1)(ii).

c. Section 732(d) TOI: [16] Distribution of property to a related partner, the basis of the distributed property is increased under section 732(d), and the partner acquired the interest in a "nonrecognition transfer."[17] ***Distributions of Property with Basis as if a Section 743(b) Adjustment Had been Applied-No Section 754 Election in Effect.***

d. Section 743(b) TOI:[18] 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 section 743(b)(1) and (c). ***Tax-Free Transfers of Partnership Interests Increasing Inside Basis-Section 754 Election in Effect.***

8. The final Treasury Regulations provide that a transfer of a partnership interest on the death of a partner is not identified as a transaction of interest (Section 743(b) TOI) or substantially similar[19] transaction.[20] The term "transfer on the death of a partner" is defined as a "transfer of a partnership interest from a partner to the partner's estate or a deemed transfer from a grantor trust owned by the partner to a trust that becomes a separate entity for Federal income tax purposes by reason of the partner's death."[21]

9. The foregoing described transactions do not become transactions of interest unless certain thresholds are met. In the case of related-party basis adjustment transactions occurring within the six1year lookback period,[22] the applicable threshold amount is $25 million or more. For related-party basis adjustment transactions occurring after the six-year lookback period, the final regulations provide an applicable threshold amount of $10 million or more.[23] The threshold amount for each taxable year is determined by calculating the sum of all basis increases resulting from all such transaction of a partnership or partners during the taxable year, with no netting of any basis decreases.[24]

10. A "nonrecognition transaction" is defined by reference to section 7701(a)(45). That Code section provides it means "any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A."[25] The proposed regulations originally defined "nonrecognition transaction" as "within the meaning of section 7701(a)(45) of the Code (other than a transfer on the death of a partner)."[26] The parenthetical carve-out was omitted from the definition, in favor of the general exception for a "transfer on the death of a partner," as mentioned above. However, the final Treasury Regulations seem to imply that a "transfer on the death of a partner" is within the meaning of a "nonrecognition transfer." This would mean that a subsequent distribution to the estate of a deceased partner under section 732(d) could fall within the definition of a Section 732(b) TOI. Furthermore, the

[16] Treas. Reg. § 1.6011-18(c)(1)(iii).

[17] Treas. Reg. § 1.6011-18(c)(2).

[18] Treas. Reg. § 1.6011-18(c)(2).

[19] *See* Treas. Reg. § 1.6011-18(d)(2).

[20] Treas. Reg. § 1.6011-18(c)(4).

[21] Treas. Reg. § 1.6011–18(b)(13).

[22] Treas. Reg. § 1.6011–18(c)(3)(ii). The six-year lookback period means the 72 months immediately preceding the first month of the taxpayer's most recent taxable year that began before January 14, 2025. Treas. Reg. § 1.6011–18(b)(11).

[23] Treas. Reg. § 1.6011–18(c)(3)(i).

[24] *Id.*

[25] § 7701(a)(45).

[26] Prop. Reg. § 1.6011–18(b)(2).

final Treasury Regulations don't address the situation where following the death of a partner, there is a deemed transfer of a partnership interest from a grantor trust to a non-grantor trust, and such transfer causes the recognition of gain due to debt in excess of basis. Because "nonrecognition transaction" is defined in terms of "gain or loss is not recognized in whole or in part for purposes of subtitle A," does this disposition fall outside the definition of "nonrecognition transfer" and thus become a "recognition transfer,"[27] as defined in the regulations? If that is the case, what are the implications of that for purposes of these transaction of interest rules?

11. A "substantially similar"[28] TOI includes, but is not limited to: (i) the TOIs described above that involve distributions by the partnership, except that the partners of the partnership are not related and one or more partners of the partnership is a tax-indifferent party that facilitates an increase in the basis of partnership property or an increase in the basis of property held by another partner in the partnership by receiving a distribution of property from the partnership or having a share of a corresponding decrease to the basis of partnership property;[29] and (ii) transaction in which a transferor transfers an interest in a partnership to a transferee that is related to the transferor in a *recognition* transaction.[30]

12. "Tax-indifferent party"[31] means a person that is either not liable for Federal income tax by reason of the person's tax-exempt or, in certain cases, foreign status, or to which any gain, or portion of any gain, that would have resulted from a "substantially similar" transaction if the property subject to a basis decrease in such transaction were sold immediately after such transaction would not result in Federal income tax liability for the person's taxable year within which such gain would have been recognized, and whose status as a tax-indifferent party is known or should be known to any other person that participates in a "substantially similar" transaction or to a partner in a partnership that participates in such a transaction. A tax-indifferent party does not include a partnership or S corporation except in a case in which a principal purpose of the use of the partnership or S corporation is to avoid tax-indifferent party status.

B. Adjusted Basis of a Partner's Interest in a Partnership (Outside Basis)

1. Importance of Outside Basis

a. One of the most important features of transfers at death is how the transfer affects the adjusted basis of the partnership interest (referred to as, "outside basis" or "outside bases") and, in turn, how the transfer may affect the adjusted basis of the assets owned by the partnership (referred to as, "inside basis" and "inside bases"). A partner's outside basis is a measure of that's partner's *after-tax* investment in the partnership. Thus, outside basis includes the partner's contribution of cash and tax basis of contributed property under section 722. Conversely, outside basis is reduced by distributions of cash and the tax basis of distributed property under section 733.

b. Before discussing how outside basis is further adjusted, it's important to understand why outside basis is so important in the context of partnership taxation:

(1) Outside basis determines, among other things, the amount of money a partnership can distribute to a partner without triggering gain. Section 731(a) of the Code provides that a

[27] Treas. Reg. § 1.6011–18(b)(6)

[28] Treas. Reg. §§ 1.6011–4(c)(4) and 1.6011–18(d).

[29] Treas. Reg. § 1.6011–18(d)(1).

[30] Treas. Reg. § 1.6011–18(d)(2).

[31] Treas. Reg. § 1.6011–18(b)(12).

partnership does not recognize gain on a distribution of money, except to the extent that the amount of money distributed exceeds the partner's basis in his or her interest.

(2) In addition, section 704(d) of the Code provides that a partner's distributive share of partnership losses is allowed only to the extent of the partner's outside basis at the end of the partnership taxable year in which the loss occurred. Any loss in excess of the partner's outside basis is disallowed. The excess loss is allowed as a deduction at the end of the first succeeding partnership taxable year (and any subsequent years) but only to the extent, if any, of the partner's outside basis at the end of that year.

(3) In the context of managing tax basis, outside basis determines (in whole or in part) the adjusted basis of property distributed to a partner. As discussed in more detail, the basis of distributed property to a partner in a current distribution is the *lesser* of the inside basis of the property and the outside basis of the distributee partner.[32] With respect to liquidating distributions of property, the basis of the distributed property is simply the outside basis of the distributee partner (as reduced by any money distributed in the same transaction).[33]

(4) Finally, outside basis determines how much gain or loss a partner will realize upon a taxable sale or exchange of his or her partnership interest.[34]

c. Importantly, and a major subject of these materials, upon the death of a partner (or a sale or exchange of a partnership interest), if there is a section 754 election in effect, the adjusted outside basis after the transfer may, in turn, cause an adjustment to inside basis under section 743(b). As discussed later, if section 2036 causes inclusion of the partnership assets in the gross estate, it can cause an unusual situation where the inside bases of the assets is greater than the outside bases of the partners.

2. Outside Basis: Contributions and Distributions

a. Under section 722, the outside basis of a contributing partner's interest in the partnership equals any money contributed and the adjusted basis of any property contributed in exchange for an interest in the partnership. Outside basis is also increased by the amount of gain (if any) recognized under section 721(b) by the contributing partner at such time.[35]

b. As discussed in more detail below, under section 733, if there is a distribution, the outside basis of the distributee partner is reduced first (but not below zero), by the amount of money

[32] § 732(a).

[33] § 732(b).

[34] §§ 741 and 742.

[35] §§ 722 and 721(b). Section 721(b) generally provides an exception to the general rule of section 721(a) that a contribution of property to a partnership in exchange for a partnership interest is not a taxable event. Section 721(b) refers to contributions to an "investment company" under section 351(e) if the partnership were incorporated. Section 351(e) of the Code and the Treasury Regulations provide that any contributions will be deemed to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor's interests, and the transferee is, in pertinent part, a corporation (partnership, in this case) more than 80 percent of the value of whose assets are held for investment and are stocks or securities, or interests in regulated investment companies, or real estate investment trusts. *See* Treas. Reg. § 1.351-1(c)(6)(i), Rev. Rul. 87-9, 1987-1 C.B. 133, PLRs 9451035, 9504025, and 200006008

distributed to such partner,[36] and then by the adjusted basis of the distributed property (as determined under section 732).[37]

c. Contributions and distributions of money include any deemed contributions and distributions that are related to the partner's share of partnership liabilities, as discussed below.

3. Adjustments to Outside Basis Due to Partnership Operations

a. Section 705 provides ongoing adjustments to outside basis, as result of partnership operations, in addition to the changes to outside basis due to contributions, distributions, and a sale of a partnership interest. These adjustments are meant to ensure that if a partner is taxed appropriately, his or her outside basis correctly reflects the after-tax investment of the partner in the partnership.

b. Section 705(a)(1) provides that outside basis will be increased by:[38]

(1) Taxable income of the partnership;[39]

(2) Tax-exempt income of the partnership;[40] and

(3) Excess of the depletion deductions over the basis of the property subject to depletion.[41]

c. Section 705(a)(2) provides outside basis will be decreased (but not below zero) by:[42]

(1) Losses of the partnership;[43]

(2) Nondeductible expenditures of the partnership that are "not properly chargeable to capital account" (meaning, non-capitalizable,[44] in this context);[45] and

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

[37] § 733(2) and Treas. Reg. § 1.733-1.

[38] Also included is an increase due to excess of the deductions for depletion over the basis of the property subject to depletion. § 705(a)(1)(C).

[39] § 705(a)(1)(A)

[40] § 705(a)(1)(B).

[41] § 705(a)(1)(C).

[42] Also included is a decrease equal to the partner's deduction for depletion for certain oil and gas property to the extent the deduction does not exceed the partner's share of the adjusted basis of such property. § 705(a)(3).

[43] § 705(a)(2)(A).

[44] The Treasury Regulations define these as "Partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures." Treas. Reg. § 1.705-1(a)(3)(ii).

[45] § 705(a)(2)(B).

(3) The amount of the partner's depletion deductions for any partnership oil and gas properties to the extent the deduction does not exceed the partner's proportionate share of the adjusted basis of such property, as allocated under section 613A(c)(7)(D).[46]

4. Outside Basis and Partnership Liabilities

a. Importantly, a partner's share of the liabilities of a partnership will be reflected in the partner's outside basis, as follows:

(1) Section 752(a) provides, "any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership."[47]

(2) Section 752(b) provides, "any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership, shall be considered as a distribution of money by such partner to the partnership."[48]

b. The practical effect of the foregoing rules is that an increase in a partner's share of partnership liabilities will increase outside basis, and a decrease in a partner's share of partnership liabilities will reduce outside basis.

c. Significantly, to the subject at hand, section 752(d) of the Code also states, in the case of a "sale or exchange" of a partnership interest, "liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships."[49] As will be discussed, this could have significant impact on how transfers at death are treated for income tax purposes when a partner dies owning an interest in a partnership with significant liabilities.

C. *Crane* and *Tufts*: Nonrecourse Liabilities, Basis, and Transfers

1. The *Crane* and *Tufts* Decisions

a. Two seminal U.S. Supreme Court cases established how debt (particularly, nonrecourse debt) is treated for income tax purposes, *Crane v. Commissioner*[50] and *Commissioner v. Tufts*.[51] In *Crane*, the taxpayer inherited, as the sole beneficiary of her husband's estate, an apartment building and lot subject to a mortgage, which secured a debt of $255,000 (and accumulated interest in arrearage of $7,042.50) on the date of death. The property was appraised for federal estate tax purposes at a value exactly equal to the principal debt. The taxpayer was allowed to continue to operate the apartment building (collecting rent, paying necessary expenses and taxes, etc.) and for 7 years, the taxpayer remitted the net rental to the mortgagee. During that period, the taxpayer reported gross rentals as income and claimed, and was allowed, deductions for taxes, operating expenses, interest on the mortgage, and

[46] § 705(a)(3).

[47] § 752(a).

[48] § 752(b).

[49] § 752(d).

[50] *Crane v. Commissioner*, 331 U.S. 1 (1947).

[51] *Commissioner v. Tufts*, 461 U.S. 300 (1983).

depreciation on the building. However, the arrearage of interest increased to $15,857.71, at which point the mortgagee threatened foreclosure on the property. Prior to foreclosure, the taxpayer sold the property, subject to the mortgage, to a third party in return for $3,000 cash (paying from that sum, $500 in sale expenses).

b. The taxpayer reported $1,250 of capital gain on the sale. Under the law at the time, only 50% of the net gain realized on a sale of a capital asset was taxable if the property had been held for more than 2 years (1/2 of $3,000 cash less $500 expenses). The taxpayer's position was that the basis of the property received at her husband's death was the net equity (excess of the value over the debt), which was zero (despite having claimed depreciation deductions). Neither the taxpayer nor the purchaser of the property assumed the mortgage, making it nonrecourse debt, so the net taxable amount realized was $3,000 minus zero adjusted basis.

c. The IRS determined that the taxpayer realized $23,767.03. The IRS contended that the value of the property inherited by the taxpayer was not the net equity, but the appraised value. Taking into account allowable depreciation on the building, the basis of the building at the time of the sale was $178,997.40. The amount realized includes the net cash of $2,500 plus the principal amount of the mortgage, totaling $257,500.

d. The Supreme Court concluded that, based on the 1938 tax act in effect at the time, the apartment building and lot received a basis adjustment at death equal to the fair market value of the property, undiminished by the mortgage (not the net equity). As to the amount realized from the purchase, the Supreme Court concluded it should include the principal amount of the mortgage, regardless of whether the mortgagor was personally liable on the debt or not. The opinion provides:[52]

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

e. The foregoing part of the opinion contains an infamous footnote. The footnote reads, "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case."[53] It wasn't until the *Tufts* case in 1983 that the Supreme Court affirmatively addressed the situation that arises when nonrecourse debt not only exceeds basis, but also exceeds the fair market value of the property securing the debt.

f. In *Tufts*, an individual builder and his wholly owned corporation formed a general partnership which purchased lots and constructed apartments for rental. On formation, no partner made any capital contributions, but the partnership secured a $1,851,500 nonrecourse mortgage to build the

[52] *Crane v. Commissioner*, 331 U.S. 1 (1947), at 14.

[53] *Id.*, fn. 37.

apartments. Subsequently, the builder admitted four friends and relatives as general partners, none of whom made any capital contributions. Over the next few years, the partners made relatively small capital contributions totaling $44,212 and took deductions for losses and depreciation of $439,972. The partnership became unprofitable due to layoffs by major employers in the area, and as a result, the partnership was unable to make the payments due on the debt. In August of 1972, each partner sold his partnership interest to a third party, receiving as consideration the purchaser's assumption of the mortgage and reimbursement of each partner's sale expenses (up to $250). The principal amount of the debt at the time of the sale was $1,851,500. The partners reported a total loss of $55,740, under the assumption the amount realized (and presumably the fair market value) was $1,400,000 with a sale of property having a basis of $1,455,740.

g. As the opinion points out, the Code provides, "In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships."[54] To that end, section 1001 of the Code provides that gain on the "sale or other disposition of property"[55] is defined as the excess of the amount realized over the adjusted basis. The amount realized is "the sum of any money received plus the fair market value of the property (other than money) received."[56] The issue in *Tufts* is what is the amount realized when there is a disposition of property encumbered by a nonrecourse mortgage that is in excess of the property's fair market value.

h. Without overruling *Crane*,[57] the Supreme Court ruled that the amount realized includes the amount of nonrecourse debt assumed by the purchaser, even if that amount exceeds the value of the property. In coming to that conclusion, the Supreme Court pointed out that when a taxpayer obtains a loan (recourse or nonrecourse), because the purchaser takes on the obligation to repay the debt in the future, the receipt of the loan is not income to the taxpayer (and the repayment of the loan principal has no tax effect). Further, when debt is used to purchase property, because of the obligation to repay, the taxpayer is entitled to include the amount of the loan of the basis in the property. Under section 1012 of the Code, the loan is part of the taxpayer's cost of the purchase of the property. *Crane* made clear that a nonrecourse loan is afforded the same treatment as a recourse loan. All of this assumes that the mortgage will be paid in full. As such, the Supreme Court concluded:

> *Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively

[54] § 752(d).

[55] § 1001(a).

[56] § 1001(b).

[57] The opinion provides, "We are disinclined to overrule *Crane*, and we conclude that the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the value of the property transferred. *Crane* ultimately does not rest on its limited theory of economic benefit; instead, we read *Crane* to have approved the Commissioner's decision to treat a nonrecourse mortgage in this context as a true loan. This approval underlies *Crane*'s holdings that the amount of the nonrecourse liability is to be included in calculating both the basis and the amount realized on disposition. That the amount of the loan exceeds the fair market value of the property thus becomes irrelevant. *Commissioner v. Tufts*, 461 U.S. 300 (1983), at 307.

will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property.[58]

i. Notably, in support of *Crane* and ultimately confirmed by *Tufts* in 1983, Treasury Regulations adopted in 1980 provide, "the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."[59] Notably, for purposes of the foregoing, the Treasury Regulations provide:

(1) "The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;"[60]

(2) "A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;"[61]

(3) "Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property;"[62] and

(4) "The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining … the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property."[63]

j. The exception for "contributions and distributions of property" between a partner and a partnership essentially turns over control to subchapter K of the Code to determine how liabilities will be treated, when dealing with partnership property and transfers of partnership interests, which will be discussed later in these materials.

k. The *Crane* and *Tufts* decisions established critically important tax principles that have far reaching implications from an income tax standpoint. They establish that debt is included in the cost basis of property acquired, whether the purchaser assumes personal liability or not (recourse or nonrecourse is irrelevant). A sale, disposition, or other transfer of property subject to nonrecourse debt (whether a sale, gift, distribution, assignment or any other situation where a different taxpayer takes ownership of the property) is treated as a "sale or other disposition" under section 1001(a) of the Code.[64] The amount realized on such "sale or other disposition" is the amount of the nonrecourse debt, even if such amount exceeds the fair market value of the property. Most importantly, there is gain to the transferor to the extent that debt is in excess of basis. These principles are incorporated throughout the Code. For

[58] *Id.* at 309-10.

[59] Treas. Reg § 1.1001-2(a)(1).

[60] Treas. Reg § 1.1001-2(a)(4)(i).

[61] Treas. Reg § 1.1001-2(a)(4)(iii).

[62] Treas. Reg § 1.1001-2(a)(4)(iv).

[63] Treas. Reg § 1.1001-2(b).

[64] *See also Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950), *cert. denied*.

example, taxpayers can trigger gain on contributions of appreciated property subject to debt to a controlled corporation in exchange for stock under section 351 of the Code.[65]

l. There is an important distinction that should be noted regarding the treatment of recourse and nonrecourse debt when the amount realized (the value of the property) is less than the debt secured by the property. In *Aizawa v. Commissioner*,[66] the taxpayer defaulted on a recourse mortgage with a balance of $90,000, at which point the property went into foreclosure and the lender purchased the property for $72,700. The basis of the property was $100,091. Relying on *Crane* and *Tufts*, the IRS argued that the amount realized was $90,000 (unpaid balance of the debt), resulting in a loss of $10,091. The Tax Court rejected this argument and ruled that the amount realized was $72,700 (the proceeds in the foreclosure and, arguably, the value of the property). The court said the full balance of the recourse debt should not be included in the taxpayer's amount realized because, unlike a situation in which property is transferred subject to a nonrecourse debt, a debtor who transfers property to a lender in satisfaction of a recourse debt remains personally liable for any remaining deficiency.[67] As a result, the taxpayer is able to increase the resulting loss to $17,300 ($90,000 minus $72,700) which represents, as the court explains, "borrowed funds which they might not repay and on which they have not yet paid a tax. But this is nothing more than the logical consequence of *Crane*…, which has been treated as sanctioning the right of a cash basis taxpayer to include the amount of an unpaid mortgage liability in his or her basis."[68] While this may seem overly generous to the taxpayer, the Tax Court explained the result is really a matter of timing, depending on future events. If, in the future, the taxpayer continues to pay down the remaining principal amount of the loan, the taxpayer will not be able to take additional losses since those losses have already been taken into account. Additionally, if any portion of the remaining debt is forgiven, the taxpayer will recognize cancellation of indebtedness income.[69]

2. Sharing of Nonrecourse Partnership Liabilities

a. As mentioned above, a partner's outside basis includes the partner's share of the partnership's liabilities. As such, any increase in a partner's share of partnership liabilities will increase the partner's outside basis. Conversely, any decrease in a partner's share of partnership liabilities will decrease the partner's outside basis and could also cause the partner to recognize income.

b. "Nonrecourse liability" is defined by exclusion in the Code. The Treasury Regulations provide a nonrecourse liability is any liability of the partnership "to the extent that no partner or related person bears the economic risk of loss for that liability."[70] As such, a partnership liability is considered recourse if any partner or related person bear the economic risk of loss for the liability.

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[65] *See* § 357(c) ("If the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.").

[66] *Aizawa v. Commissioner*, 99 T.C. 197 (1992).

[67] *Cf. Chilingirian v. Commissioner*, 918 F.2d 1251 (6th Cir. 1990), *affg.* T.C. Memo. 1986-463, *R. O'Dell & Sons Co. v. Commissioner,* 169 F.2d 247 (3d Cir. 1948), *affg.* 8 T.C. 1165 (1947), and *Diamond v. Commissioner,* 43 B.T.A. 809 (1941) where the courts ruled that the discharge of indebtedness and the foreclosure are so closely related, that the discharge should be treated as part of the amount realized under the ruling in *Tufts.*

[68] *Aizawa v. Commissioner*, 99 T.C. 197 (1992), at 201. *See also* Treas. Reg. § 1.1001-2(a)(iii) which provides, "The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability)."

[69] *See* § 61(a)(1). *See also* § 108 for certain exclusions that are available with cancellation of indebtedness income.

[70] Treas. Reg. § 1.752-1(a)(2).

Conversely, a liability is considered nonrecourse to the extent no person or related person bears such risk of loss. In the context of outside basis, generally, recourse liabilities increase outside basis only as to the partner who bears economic risk of loss, whereas nonrecourse liabilities increase basis proportionately among all of the partners. For purposes of these materials, unless otherwise indicated, it is assumed that all partnership liabilities are nonrecourse.

c. Any increase in a partner's share of liabilities (including any assumption by a partner of any partnership liabilities) is treated as contribution of cash by the partner in the partnership, thereby increasing outside basis. Any decrease is treated as a distribution of cash to the partner, thereby reducing outside basis and possibly resulting in the recognition of gain if the amount of the deemed distribution exceeds available outside basis. If property that is subject to a liability is contributed to or distributed from a partnership, the transferee is deemed to assume the liability but only to the extent the liability is not in excess of the fair market value.

d. A complete discussion of how nonrecourse liabilities are shared by partners is beyond the scope of this outline, but the Treasury Regulations generally provide that a partner's share of such liabilities is the sum of the following three "tiers":[71]

(1) Tier 1: The partner's share of "partnership minimum gain" (gain that would be realized if all property subject to nonrecourse liability is sold in full satisfaction of the liabilities and for no other consideration, as discussed in more detail later in these materials);[72]

(2) Tier 2: Amount of taxable gain that would be allocated to the partner under section 704(c) (arising because the partner contributed property to the partnership and the partnership still holds the property) if the partnership disposed of all partnership property subject to nonrecourse liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration; and

(3) Tier 3: The partner's share of "excess nonrecourse liabilities" (liabilities not allocated above), which as discussed below, are generally allocated in accordance with each partner's share of profits.

e. A partner's share of partnership minimum gain (Tier 1) is determined in accordance with the section 704(b) Treasury Regulations.[73] In general, partnership minimum gain is the excess of partnership nonrecourse liabilities over the section 704(b) value of the partnership assets they encumber.[74]

> **Example:** A and B form AB partnership. A contributes depreciable property subject to a $60x nonrecourse liability. The property has an adjusted basis of $40x and a fair market value of $100x. The initial section 704(b) book value is $100x. B contributes $100x in cash. A and B are equal partners.
>
> Immediately after the transfer of the property, there is actually no "partnership minimum gain," despite the fact that the nonrecourse liabilities of $60x exceeds the basis of the

[71] Treas. Reg. § 1.752-3(a)(1) through (a)(3).

[72] "Minimum gain" is defined in Treasury Regulation in section 1.704-2(d) and "partner's share of minimum gain" is defined in Treasury Regulation in section 1.704-2(g)(1).

[73] Treas. Reg. § 1.704-2(g).

[74] Treas. Reg. § 1.704-2(d)(3).

property of $40x. The reason for this surprising result is because the section 704(b) book value of the property ($100x) is greater than the nonrecourse liability and it is book value, not adjusted basis, that is used to compute minimum gain. As a result, none of the $60x is allocated in Tier 1. It is Tier 2.

If the section 704(b) book value is depreciated below $60x, minimum gain will be created to that extent. The creation of this minimum gain will cause a reallocation of nonrecourse liabilities that were previously allocated under Tiers 2 and 3.

f. The Treasury Regulations provide that a portion of a partner's built-in gain under section 704(c)[75] (and "reverse" section 704(c) rules under the section 704(b) Treasury Regulations)[76] will attribute nonrecourse liabilities to a partner. Under Tier 2, a partner is allocated nonrecourse liabilities in an amount equal to the gain that the partner would realize under section 704(c) (and "reverse" section 704(c)), if the partnership sold the assets encumbered by the nonrecourse liabilities for no consideration other than those liabilities. As noted above, for section 1001 purposes, "Contributions … of property between a partner and a partnership are not sales or other dispositions of property."[77] As a result, a partner can contribute property subject to nonrecourse liabilities that are in excess of the adjusted basis of the encumbered property without recognizing gain. The Tier 2 allocation ensures that the contribution to the partnership does not relieve the partner of that debt because partnership rules allocate that partnership liability to the contributing partner.

g. With respect to Tier 3 allocations, the Treasury Regulations provides a number of methods[78] to determine a partner's share of "excess nonrecourse liabilities."

(1) Under one method, a partner's share of "excess nonrecourse liabilities" is generally "determined in accordance with the partner's share of partnership profits" under all of the "facts and circumstances relating to the economic arrangement of the partners"[79] (often referred to as the "facts and circumstance" method). As a result, in a "pro rata" partnership (as is often the case with family partnerships), when no partner has contributed property to the partnership, nonrecourse debt will also be shared pro rata.

(2) The partnership agreement may specify a share of nonrecourse liabilities for the partners that are "reasonably consistent with allocations…of some other significant item of partnership income or gain"[80] (often referred to as the "significant item" method).

(3) Alternatively, excess nonrecourse liabilities may be allocated among partners in a manner that deductions attributable to those liabilities are reasonably expected to be allocated (often referred to as the "alternative" method).[81]

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[75] Treas. Reg. § 1.752-3(a)(2).

[76] *See* Treas. Reg. §§ 1.704-1(b)(2)(iv)(*f*), 1.704-1(b)(2)(iv)(*r*), and 1.704-3(a)(6).

[77] Treas. Reg § 1.1001-2(a)(4)(iv).

[78] A partnership may change methods from year to year. *See* Treas. Reg. § 1.752-3(a)(3).

[79] Treas. Reg. § 1.752-3(a)(3).

[80] *Id.*

[81] *Id.*

(4) Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property or property for which reverse section 704(c) allocations are applicable where such property is subject to the nonrecourse liability, to the extent that such built-in gain exceeds the gain described in section 1.752-3(a)(2) of the Treasury Regulations with respect to such property (often referred to as the "additional" method).[82]

h. The IRS has ruled,[83] under the facts and circumstances test, that section 704(c) allocations must be taken into account in allocating excess nonrecourse deduction to the extent they are not taken into account in Tier 2.

> **Example:** A and B form AB partnership. A contributes depreciable property subject to a $60x nonrecourse liability. The property has an adjusted basis of $40x and a fair market value of $100x. The initial section 704(b) book value is $100x. B contributes $100x in cash. A and B are equal partners.
>
> Assume AB Partnership uses the "traditional method" for section 704(c) purposes (discussed later in these materials). As noted in the previous example, which has the same facts, no partnership liabilities are allocated to A and B under Tier 1 (partnership minimum gain). Under Tier 2, $20x of nonrecourse liabilities are allocated to A only (section 704(c) tier). That leaves $40x of nonrecourse liabilities to be allocated under Tier 3.
>
> Based on these facts and section 704(b), A and B will share gain equally. Notwithstanding the foregoing and the fact that the Treasury Regulations rely on allocations of profit in Tier 3 and do not mention section 704(c) in this method, the IRS provides (under the facts and circumstances method), A must be allocated in Tier 3 more than one-half of the excess nonrecourse liabilities.

D. Outside Basis and the Unitary Basis Rule

1. Introduction to the Unitary Basis Rule

a. Estate planners are often surprised to learn that each partner in a partnership has a "unitary basis" in his or her partnership interest, even if the partner has different classes of partnership interests (general and limited, preferred and common, etc.) and even if the partner acquired the partnership interests in different transactions.[84] This is in stark contrast to the "separate lot" rules applicable to shares of corporate stock when such separate lots can be "adequately identified."[85]

b. The unitary basis rule is based on and explained in Revenue Ruling 84-53,[86] which described four different situations involving the sale of a partnership interest, three of which involve

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[82] *Id.*

[83] Rev. Rul. 95-41, 1995-1 C.B. 132, and T.D. 8906, 2002 C.B. 470 (Oct. 31, 2000).

[84] Rev. Rul. 84-53, 1984-1 C.B. 159. *Cf.* PLR 200909001 (the unitary basis rule does not apply to publicly traded partnership interests).

[85] *See* Treas. Reg. § 1.1012-1(c). Even if lots cannot be identified, then a first-in, first-out accounting convention is used to determine gain or loss.

[86] Rev. Rul. 84-53, 1984-1 C.B. 159. *See also* Rev. Rul. 84-52, 1984-1 C.B. 157, endorses the unitary basis concept and which involved a general partnership converted to a limited partnership. Two of the general partners in the general

liability shifts. The underlying authority for the position taken in the ruling is section 1.61-6(a) of the Treasury Regulations, which provides:

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

c. The four situations described in the ruling are based on the following common facts:

(1) In 1978, Partnership Y was formed for the purpose of investing and trading in stocks and securities. Y has a calendar taxable year.

(2) A contributed $50x to Y in exchange for a general partner interest, entitling A to a 50 percent interest in all partnership distributions and in partnership income, gain, loss, and deduction. B contributed $50x to Y in exchange for a limited partner interest, entitling B to a 50 percent interest in all partnership distributions and in partnership income, gain, loss, and deduction.

(3) Since formation, the partnership has made cash distributions in amounts equal to its total income (including tax-exempt income).

d. Situation 1

(1) In situation 1, on January 1, 1980, when the stock and securities of Y had decreased in value from $100x to $64x, B sold to A one half of B's limited partner interest for $16x, which interest A holds as a limited partner. On January 1, 1982, when the stock and securities of Y has risen in value from $64x (its 1980 value) to $120x, A sold to C one-half of A's general partner interest for $30x. Immediately prior to the sale, A's entire partnership interest had a fair market value of $90x and the transferred portion of the interest had a fair market value of $30x.

(2) The IRS concluded, prior to the sale of one-half of B's limited partner interest to A, the adjusted basis of B's entire partnership interest was $50x. Because the fair market value of the transferred portion of B's interest ($16x) is one-half of the fair market value of B's entire partnership interest ($32x), $25x (1/2 of $50x) of adjusted basis must be allocated to the interest transferred by B. B sustained a $9x loss ($16x - $25x) on the sale to A. The adjusted basis of the remainder of B's partnership interest is $25x.

(3) In addition, the IRS concluded, prior to the sale of one-half of A's general partner interest to C, the adjusted basis of A's entire partnership interest was $66x. Because the fair market value of the transferred portion of A's interest ($30x) is one-third of the fair market value of A's entire partnership interest ($90x), $22x (1/3 of $66x) of the adjusted basis must be allocated to the portion of the interest transferred by A. A realizes an $8x gain ($30x - $22x) on the sale to C. The basis of the remainder of A's partnership interest is $44x.

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partnership converted their interest into a general partner interest and a limited partner interest in the limited partnership.

(4) Significantly, the IRS also stated the results would be the same to A if instead, A sold to C the limited partner interest acquired earlier from B.

e. Situation 2

(1) The facts are the same as in situation 1, except that, in 1981, Y borrowed $80x recourse which was invested in securities that became worthless on December 31, 1981. Furthermore, immediately prior to A's sale to C, A's entire partnership interest had a fair market value of $30x and the transferred portion of A's interest had a fair market value of $10x.

(2) The tax consequences of B's sale of B's limited partnership interest to A are the same as situation 1.

(3) As to the sale to C, in 1981, A's basis in A's entire partnership interest was increased from $66x to $146x as a result of the $80x recourse borrowing (which increases only the basis of A, the sole general partner, under sections 752(a) and 722 of the Code), and was decreased to $86x as a result of the $60x loss allocated to A (owning 75% of the partnership interests the year when the securities became worthless). Thus, prior to the sale of one-half of A's general partner interest to C, the adjusted basis of A's entire partnership interest was $86x. To take into account the effect of the partnership liability sharing rules, $80x (A's share of all partnership liabilities) is subtracted from $86x, leaving $6x. Because the fair market value of the transferred portion of A's interest ($10x) is one-third of the fair market value of the entire interest ($30x), $2x (1/3 of $6x) of the remaining adjusted basis must be allocated to the transferred portion of A's general partner interest. The sum of that amount ($2x) plus the amount of partnership liabilities from which A is discharged on the disposition of the transferred portion of A's general partner interest ($40x), or $42x, equals the adjusted basis of the transferred portion of the interest. A realizes an $8x gain ($10x + $40x - $42x) on the sale to C.

(4) The basis of the remainder of A's partnership interest is $44x ($86x - $42x).

f. Situation 3

(1) The facts are the same as in situation 2 except that, on January 1, 1982, A sold A's entire limited partner interest to C for its fair market value of $10x (rather than one-half of A's general partner interest).

(2) The tax consequences of B's sale of B's limited partnership interest to A are the same as situation 1.

(3) As to the sale to C, prior to the sale of A's limited partner interest to C, the adjusted basis of A's entire partnership interest was $86x. To take into account the effect of the partnership liability sharing rules, $80x (A's share of all partnership liabilities) is subtracted from $86x, leaving $6x. Because of the fair market value of the transferred portion of A's limited partner interest ($10x) is one-third of the fair market value of A's entire interest ($30x), $2x (1/3 of $6x) of the remaining adjusted basis must be allocated to the transferred limited partner interest. The sum of that amount ($2x) plus the amount of partnership liabilities from which A is discharged on the disposition of the transferred limited partner interest ($0x), or $2x, equals the adjusted basis of the transferred portion of the interest. A realizes an $8x gain ($10x - $2x) on the sale to C.

(4) The basis of the remainder of A's partnership interest is $84x ($86x - $2x).

g. Situation 4

(1) The facts are the same as in situation 1 except that, in 1981, Y borrowed $96x recourse which is invested in securities that became worthless on December 31, 1981. Furthermore, immediately prior to A's sale to C, A's entire partnership interest had a fair market value of $18x and the transferred portion of A's interest had a fair market value of $6x.

(2) The tax consequences of B's sale of B's limited partnership interest to A are the same as situation 1.

(3) As to the sale to C, in 1981, A's basis in A's entire partnership interest was increased from $66x to $162x as a result of the $96x recourse borrowing and was decreased to $90x as a result of the $72x loss allocated to A that year when the securities became worthless. Thus, prior to the sale of one-half of A's general partner interest to C, the adjusted basis of A's entire partnership interest was $90x. In this situation, A's share of all partnership liabilities ($96x) exceeds the adjusted basis of A's entire interest ($90x). Thus, the adjusted basis of the transferred portion of A's general partner interest equals $45x, the amount which bears the same relation to A's adjusted basis in the entire interest ($90x) as the amount of partnership liabilities from which A is discharged on the disposition of the transferred portion of the general partner interest ($48x) bears to A's share of all partnership liabilities ($96x). A realizes a $9x gain ($48x + $6x - $45x) on the sale of C.

(4) The basis of the remainder of A's partnership interest is $45x ($90x - $45x).

h. As an explanation for its holdings, the IRS sets forth a two-step process for determining the total amount of basis allocated to the sold partnership interest:

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

i. Unitary basis is determined on a partnership-by-partnership basis. There does not seem to be a statutory rule that the unitary basis of the partner must be aggregated. Even, so it seems, if a partner has an interest in 2 or more partnerships that are identical in all respects (including the interests of other partners), except perhaps the assets in the partnership. This may have important implications in

estate planning as it bears to reason that it might make sense for taxpayers to segregate low basis and high basis assets into different partnerships.

2. Grantors and Grantor Trusts: Unitary Basis and Other Tax Implications

a. Generally

(1) Revenue Ruling 85-13[87] provides that a grantor, as the owner of all assets in a grantor trust, will be treated, for all Federal income tax purposes, and as such, the trust is not a separate taxpayer from the grantor. The deemed-owned trust and the deemed owner are a single taxpayer. From a unitary basis standpoint this means that if the deemed owner and the deemed-owned trust are partners in a partnership, they are deemed to have a unitary basis in their collective partnership interests.

(2) Unitary basis allows a deemed owner and a deemed-owned trust to combine and share their respective outside bases. As noted, in the context of family-owned partnerships, it is unusual to have special (disproportionate) allocations of tax items (i.e., losses) to one partner. However, disproportionate distributions that reduce a partner's interest (i.e., partial redemption of a partner's interest) are common. This would allow, for example, a deemed owner and deemed-owned trust to use the combined unitary basis for the benefit of one partner over the other.

> **Example:** G and G's grantor trust (T) are equal partners of GT Partnership. GT Partnership has an additional 1% partner that is ignored for purposes of this example. Both G and T have an outside basis in their respective partnership interest of $30x and a capital account balance of $100x. Thus, G and T have a unitary basis of $60x. GT Partnership makes a disproportionate distribution of a partnership asset that has an inside basis of $50x and a fair market value of $50x to T, reducing T's partnership interest by one-half (T's capital account is reduced to $50x). After the distribution, T's interest in GT goes from 50% to a 33.3% interest, and T holds the distributed asset with a basis and fair market value of $50x. G and T's remaining unitary basis is $10x. G's capital account is $100x, and T's capital account is $50x.
>
> If T is a grantor trust the assets of which will not get a "step-up" in basis on the death of the grantor, then this is an indirect way of allowing T to get the benefit of G's outside basis. Of course, this type of basis management could have been accomplished with a "swap" power under section 675(4)(C) of the Code, but if the treatment of sale or exchange treatment between a grantor and grantor trust is changed,[88] this might be an indirect and non-taxable way to achieve a similar result.

(3) Not only does Revenue Ruling 85-13 have unitary basis implications, it also means that if, for example, a deemed owner makes a contribution of property to a partnership and the

[87] Rev. Rul. 85-13, 1985-1 C.B. 184.

[88] For example, in 2021, the House Ways and Means Committee introduced a draft of a tax bill (as part of the Build Back Better plan) that included a new section 1062, which would have applied to certain transactions between "deemed owners" and their deemed-owned trusts and which would have effectively revoked Revenue Ruling 85-13. The proposed section 1062 provided, "In the case of any transfer of property between a trust and the [sic] a person who is the deemed owner of the trust (or portion thereof), such treatment of the person as the owner of the trust shall be disregarded in determining whether the transfer is a sale or exchange for purposes of this chapter." Section 138209 of the September 13, 2021, House Ways and Means Committee proposal for H.R. 5376, which was modified on October 28, 2021, and November 3, 2021, and in both subsequent modifications, the proposal for section 1062 was omitted.

partnership then distributes the property to the contributor's deemed-owned trust, this transfer is effectively treated as a distribution back to the contributing partner (because the deemed owner and the deemed-owned trust are treated as the same taxpayer). The ramifications of this combination of Revenue Ruling 85-13 and the unitary basis rule are seemingly limitless.[89] Some of these implications are explored herein.

b. Contributions and Distributions

(1) Contributions of cash or high basis property by a deemed owner or deemed-owned trust has the effect of increasing the shared unitary basis for the benefit of the non-contributing partner. As the example above illustrates, subsequent distributions can be used to disproportionately transfer that basis to the deemed-owned trust or to the deemed owner. If property is contributed, as discussed later, practitioners should be careful about the disguised sale rules, but there seems to be no issues with possible mixing bowl transactions.

(2) As discussed herein, liquidating distributions can result in gain *or loss*, and if property is distributed in liquidation of a partner's interest, then the adjusted basis of the distributed property in the hands of the distributee can be equal to, lower than, or *greater than* the inside basis of the property prior to the distribution. In contrast, non-liquidating "current" distributions can only result in gain (not loss), and if property is transferred as part of a current distribution, then the adjusted basis of the distributed property in the hands of the distributee can be equal to or lower than the inside basis of the property prior to the distribution. In other words, current distributions of property can *only* result in a reduction of basis on distributed property, but a liquidating distribution of property can result in a reduction and increase in basis on the property.

(3) In the context of grantors and grantor trusts, if a grantor redeems his or her entire interest in a partnership for property but an IDGT continues to have an interest in the partnership, it means that the distribution is considered a current distribution, rather than a liquidating distribution (because the grantor is deemed to still have an interest in the partnership). This could mean the grantor would not be able to take a capital loss upon exiting the partnership, and it might affect the grantor's basis in the distributed property.

> **Example:** G and G's grantor trust (T) are partners in GT Partnership. GT Partnership has an additional 1% partner that is ignored for purposes of this example. G's outside basis and capital account balance are $60x and $50x respectively. T's outside basis and capital account balance are $5x and $50x respectively. G and T's shared unitary basis and combined capital account balances are $65x and $100x. G is leaving the partnership, and to that end, GT partnership will redeem G's interest by making a distribution to G having a value equal to G's capital account balance of $50x.
>
> If GT distributes $50x of cash to G, G will not recognize any gain because G (without regarded to unitary basis) has sufficient outside basis to absorb the distribution (G's outside basis is reduced to $10x). Although G is no longer a partner in GT Partnership, G will not be able to recognize a loss because G is the deemed owner of the assets of T, and T is still a partner in GT Partnership. After the liquidation, it seems that T's outside basis is increased to $15x and capital account is $50x.

[89] *See* H. Grace Kim, *Application of Unitary Basis in Partnership Interests*, 54 Tax Mgmt. Memo. 103 (2013), for an excellent discussion of the complications caused by the unitary basis rule in conjunction with other provisions of subchapter K including allocations of income under section 704(d) of the Code, distributions of cash and property to partners under sections 731 and 732 of the Code, and other situations involving transfers of partnerships.

If, instead, GT Partnership distributes an asset that has an inside basis of $30x and a fair market value of $50x, the distribution will be treated as a non-liquidating "current" distribution even though G is leaving the partnership because T is still a partner in GT Partnership. As such, the distribution will be non-taxable but the asset will have an adjusted basis of $30x in G's hands (instead of $60x if this was a liquidating distribution). G's outside basis will be reduced to $20x, and after the liquidation it seems that T's outside basis will be increased to $25x (and a capital account that remains at $50x).

If G wishes to recognize a loss on the distribution of $50x to G, G could convert T to a non-grantor trust. As discussed later, assuming there are no partnership liabilities or other debts, this conversion would not be a taxable event. Upon conversion, the unitary basis rule is no longer applicable, and the liquidating distribution of $50x of cash to G may allow G to recognize a -$10x capital loss, assuming G's resulting outside basis is $60x after conversion. On the other hand and discussed later, the conversion may result in G having only $32.5x in outside basis, which would then mean the liquidating distribution of $50x will result in $17.5x of gain. It seems the latter result, as unusual as it may seem, may be the right outcome.

c. Disguised Sale and Mixing Bowl Implications

(1) As discussed later, if a partner contributes appreciated property to a partnership and, generally within two years of the contribution, such contributing partner receives a distribution of any other property or cash, then the partner will recognize gain with respect to the contributed property under the "disguised sale" rules. Practitioners may be lulled into thinking that because Revenue Ruling 85-13 treats deemed owners and deemed-owned trusts as the same taxpayer that the disguised sale rules are not applicable. That is not the case unfortunately. As discussed, there are three types of disguised sales: (i) sales of property by a partner to the partnership; (ii) sales of property by the partnership to a partner; and (iii) a sale of a partnership interest by one partner to another partner. Only the latter would be exempt from disguised sale treatment if such sale occurred between a deemed owner and deemed-owned trust.[90] The other two disguised sales involve the partnership, which is a separate taxpayer (notwithstanding that the partnership itself is not subject to income tax).[91]

Example: G G's grantor trust (T) are partners in GT Partnership. GT Partnership has an additional 1% partner that is ignored for purposes of this example. Ignoring the third partner's interest, G and T each own a 50% interest in GT Partners. G contributes $100x cash to the partnership, and T contributes property with an adjusted basis of $30x and fair market value of $100x (in exchange for additional partnership interests, but each still holding a 50% interest in GT Partnership). Soon after these contributions, the partnership transfers the contributed property to G.

Assuming this is a disguised sale, this is treated as a sale of the contributed property by the partnership to G in a transaction where G is not treated as a partner.[92] The partnership is treated as having sold the contributed property, the gain of which is allocated to T because

[90] If proposed section 1062 or other similar provision is enacted, it would cause this third version of the disguised sale rules (taxable sale of a partnership interest) to be taxable because it involves a transfer between a deemed owner and deemed-owned trust that would be treated as a taxable sale.

[91] *See* § 701.

[92] *See* §§ 707(a)(1) and 707(a)(2)(B).

this is section 704(c) property (rather than to all of the partners under section 704(b)). This is not treated as a distribution of property to G in his or her capacity as a partner. Ignoring time value of money, $70x of gain is recognized on the sale. G holds the property with a cost basis of $100x with a new holding period. The unitary basis shared between G and T will be increased by $70x. Note: if more than two years passes between the contributions and the distribution, then the transaction would most likely not be considered a disguised sale.

If, prior to these contributions, T had exchanged the property for $100x cash, under Revenue Ruling 85-13 there would be no gain. The property would be held by G with a carryover holding period and an adjusted basis of $30x. G and T could then contribute the property and cash to the partnership without any gain. Query: because the disguised sale rule is determined on a facts and circumstances test, should the original transaction above be a taxable disguised sale at all?

If the entity was, instead, a LLC, and G and T were the only members, then such entity would by default be a disregarded entity. Any transfers to or from the LLC would be ignored and there would be no gain. Note, however, if proposed section 1062 or other similar provision becomes law, then there would be a taxable event and $70x gain would result.

(2) As discussed herein, a "mixing bowl transaction" occurs (resulting in gain or loss), when a partner contributes appreciated (or loss) property to a partnership and within 7 years, either: (1) the contributed property is distributed to *another partner*, or (2) property *(other than the contributed property)* is distributed to the contributing partner. Because Revenue Ruling 85-13 treats deemed owners and deemed-owned trusts as the same taxpayer, when one partner makes a contribution of property and such property is distributed to the other partner, even within 7 years of contribution, neither of the mixing bowl triggers can occur. Both the deemed owner and the deemed-owned trust are treated as the contributor, regardless of which partner actually makes the contribution (in other words the contributed property is not contributed to "another partner"). Further, when the contributed property is distributed to the other partner, because the other partner is treated as the contributor, it is treated as if the contributed property is being distributed to the contributing partner. Note that when a mixing bowl transaction occurs, it is an allocation of pre-contribution gain, not a transaction between partners. This distinction will be critical if proposed section 1062 or other similar provision becomes law, as there is no "transfer" between the deemed owner and deemed-owned trust, which is required under section 1062.

d. Partnership Liabilities

(1) As mentioned above, partnership liabilities increase the outside basis of the partner who bears the economic risk of loss if the liability is a recourse, and if the liability is nonrecourse, then the outside basis increase is shared proportionately among all of the partners. Any increase in a partner's share of liabilities (including any assumption by a partner of any partnership liabilities) is treated as a contribution of money by the partner to the partnership, thereby increasing basis.[93] Any decrease is treated as a distribution of money to the partner, thereby reducing basis and possibly resulting in the recognition of gain if the amount of the deemed distribution exceeds available outside basis.[94]

[93] § 722 and Treas. Reg. § 1.752-1(b).

[94] §§ 733, 731(a), 751 and Treas. Reg. § 1.752-1(c).

(2) An extension of the unitary basis rule is that a partner (i.e., deemed owner and his or her deemed-owned trust) will have one unitary liability allocation amount under section 752 of the Code. In a technical advice memorandum,[95] the IRS concluded that the deemed distribution under section 752(b) of the Code from a reduction in a partner's share of nonrecourse liabilities should be applied against the partner's entire basis in both its limited and general partnership interests. The limited partnership interests of two partners, A and B, each having both a general partner and a limited partnership interest, were liquidated. As a result of the liquidation of the limited partnership interests, the nonrecourse liability allocation of A and B decreased. The IRS agent argued that A and B each had a separate basis as a limited partner and as a general partner, and that to the extent the decrease in liability allocation exceeded their basis in the limited partnership interests, they would recognize gain under section 731 of the Code. The IRS National Office disagreed with the agent, specifically stating that A and B had a single adjusted basis with respect to their interests in the partnership. Because each of A and B had a basis in the partnership exceeding the amount of money deemed to be distributed under section 752(b) of the Code, the liquidation of their limited partnership interests did not result in gain recognition to either A or B under section 731 of the Code.

(3) In addition to a partnership simply paying off a portion or all of its debts, reductions in partnership liabilities can occur in a number of different ways: (1) upon liquidation of a partner's interest in a partnership, that partner's share of the partnership's nonrecourse liabilities are eliminated (reduced), thereby causing a deemed distribution of money; (2) when there is a distribution of partnership property to a partner subject to a debt, the remaining partners have a reduction in their share of partnership liabilities equal to the amount of that debt; and (3) when a partner sells all or a portion of its partnership interest, the selling partner's share of partnership nonrecourse debt will be reduced (and the purchasing partner has its share of liabilities increased).[96] As pointed out by the technical advice memorandum discussed above, the combined unitary basis of a partner (i.e., deemed owner and deemed-owned trust) can help alleviate the income tax consequences of a reduction in partnership liabilities.

> **Example:** G and G's grantor trust (T) are partners in a partnership. G and T each have a 20% interest in the partnership, and each of them have an outside basis in the partnership of $10x and a capital account of $20x. The partnership has $30x of nonrecourse liabilities, and G and T's proportionate share of those liabilities is $6x each. The partnership is going to liquidate T's interest in the partnership by distributing $20x in cash. Under section 752(b), T's departure from the partnership causes T's share of partnership liabilities to decrease, and there is a deemed distribution of money equal to $6x. If the unitary basis rule did not apply, T's outside basis would be reduced to $4x, and the distribution of $20x to T would result in $16x of gain under section 731(a). However, with the unitary basis rule, outside basis starts at $20x (not $10x), reduced by $6x for the decrease in partnership liabilities under section 752(b), and reduced further by $20x under section 731(a). The liquidation results in $6x of gain (not $16x).
>
> G's resulting outside basis in the partnership is not $0x, because the liquidation of T causes G's percentage ownership to increase from 20% to 25%. The incremental increase in partnership interest (+5%) increases G's resulting outside basis to $1.5x (5% of $30x of nonrecourse liabilities). Of course, if G's partnership interest is included in G's estate, the partnership interest will get a step-up in basis under section 1014. Further, if the

[95] TAM 8350006.

[96] In actuality, the reduction in the transferor partner's share of liabilities is treated as an amount realized under section 1001. *See* Treas. Reg. §§ 1.752-1(h) and 1.1001-2(a)(4)(v).

partnership has a section 754 election in place, the basis of the assets inside the partnership will get an upward inside basis adjustment under section 743(b).

E. Gratuitous Transfers of Partnership Interests (with Partnership Liabilities)

1. Gratuitous Transfers Generally

a. When a donor makes a gratuitous transfer of a partnership interest to a donee, even if the donee is a separate taxpayer (e.g., not a grantor trust of the donor), generally no gain or loss is recognized on the transfer. The donee has the donor's basis in the interest received, increased by any gift tax paid.[97] The transferred basis is, however, limited to fair market value of the partnership interest, for purposes of determining a loss.[98] Given the foregoing limitation with respect to losses, valuation discounts could, in fact, limit the ability of the donee to recognize a portion of a subsequent loss.

b. If the donor transfers only a portion of his or her partnership interest, only a portion of the donor's unitary outside basis is transferred. One would assume that a pro rata portion of the donor's outside basis would also be transferred to the donee. In other words, if a donor owns a partnership interest having an outside basis of $100 and the donor gifts 55% of his or her partnership interest to a donee (who is not a grantor trust), then the donee will now own a partnership interest with an outside basis of $55. Surprisingly, that may not always be the case.

c. As mentioned above, in Revenue Ruling 84-53,[99] in the context of calculating outside basis of a transferred partnership interest, the IRS ruled, "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest."[100] Under this calculation, if the gift of the 55% partnership interest carries a valuation discount (which it should since that reflects fair market value), then the 55% interest would actually transfer less than $55 of basis.

d. In contrast, when determining the capital account balance associated with a transferred interest, the Code provides, "upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner."[101] This is the same approach when dealing with transfers by a contributing partner of section 704(c) property (discussed later). With respect to transfers of partnership interests, the Treasury Regulations provide, for section 704(c) purposes, "If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built- in gain or loss proportionate to the interest transferred must be allocated to the transferee partner."[102]

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[97] § 1015(d).

[98] § 1015(a).

[99] Rev. Rul. 84-53, 1984-1 C.B. 159.

[100] *Id.* The ruling relies on Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

[101] Treas. Reg. § 1.704-1(b)(2)(iv)(l). *See also* Treas. Reg. § 1.704-1(b)(5), Ex. 13.

[102] Treas. Reg. § 1.704-3(a)(7).

e. For "mixing bowl" purposes (discussed later), with respect to transfers of partnership interests:

(1) Section 704(c)(1)(B) provides if contributed property is distributed within seven years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution.[103] The Treasury Regulations provide, "The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner."[104]

(2) Section 737 provides if a partner contributes appreciated property to the partnership and, within seven years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally will be required to recognize gain upon the receipt of such other property.[105] Thus, section 737 only applies to property received that was not otherwise contributed by such partner. As discussed in more detail in the mixing bowl transaction section in these materials, although there is some debate as to whether a transferee under section 737 is treated as a contributing partner, the consensus view is that a transferee steps into the shoes of the transferor as the contributing partner.

2. Gratuitous Transfers with Partnership Liabilities

a. As discussed above, the *Crane* decision and its progeny established the doctrine that liabilities assumed or taken subject to in connection with a "sale or exchange" are included as part of the purchaser's basis and the seller's amount realized. This doctrine has been extended to charitable contributions and to intrafamily gifts.[106] As noted, section 752(d) extends the doctrine, "In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships."[107] Further, it should be noted that the exception for "sale and exchange" treatment with regard to transfers between partners and partnerships only applies to contributions and distributions.[108]

b. The question at hand is then if a donor makes a lifetime gratuitous transfer of a partnership interest to a donee and the partnership interest subjects the donee to partnership liabilities in excess of the outside basis associated with gift, does the donor recognize gain to the extent of the excess?

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[103] § 704(c)(1)(B).

[104] Treas. Reg. § 1.704-4(d)(2).

[105] §§ 704(c)(1)(B) and 737.

[106] *See Diedrich v. Commissioner*, 457 U.S. 191 (1982) (donee's obligation to pay donor's gift tax liability treated as an amount realized for income tax purposes), *Winston F.C. Guest*, 77 T.C. 9 (1981) (*acq.*), *Est. of Aaron Levine*, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2d Cir. 1980), *Teofilo Evangelista*, 71 T.C. 1057 (1979), *aff'd*, 629 F.2d 1218 (7th Cir. 1980). *See* Treas. Reg. §§ 1.1001-2(a)(1), 1.1001-2(a)(4)(i), 1.1001-2(a)(4)(ii), 1.1001-2(a)(4)(iii) (amount realized on sale or disposition includes both recourse and nonrecourse liabilities, "disposition" includes gift), Treas. Reg. § 1.1011-2(a)(3) (automatic realization of liabilities in connection with charitable contribution), Rev. Rul. 75-194, 1975-2 C.B. 80 (realization by taxpayer making charitable contribution of partnership interest to extent of partner's share of partnership liabilities at the time of transfer), and Rev. Rul. 70-626, 1970-2 C.B. 158 (gift of pledged securities results in amount realized to taxpayer to extent of debt).

[107] § 752(d).

[108] Treas. Reg. § 1.1001-2(a)(4)(iv)

Please note the distinction between a transfer of a partnership interest that is subject to (encumbered) by a liability, in contrast to a partnership interest that includes a share of partnership liabilities.

c. As noted above, section 752(d) provides, "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."[109] The critical issue is whether section 752(d) should be interpreted broadly, applying to all dispositions including a gratuitous transfer. This is the IRS's position.[110]

d. The IRS's position is that section 752(d) is applicable to all transfers of partnership interests.[111] Inherent in this position is that the "sale or exchange" language in section 752(d), which was enacted as part of the 1954 Code, was intended to include all transfers, not as a specific exception for partnerships from the *Crane* doctrine. The preamble to the Treasury decision that promulgated the section 1.1001-2 (titled "discharge of liabilities") Treasury Regulations, states, the following:[112]

> The Treasury decision makes it clear that contributions and distributions of encumbered property between a partner and a partnership are not sales or other dispositions for purposes of section 1001. Thus, such transactions are subject to the partnership rules relating to contributions and distributions. The Treasury decision also makes it clear that the amount realized by the sale or other disposition of a partnership interest includes the amount of partnership liabilities from which a transferor is discharged as a result of the sale or other disposition. Similarly, the transferee treats such liabilities as part of the cost of the partnership interest rather than as a contribution of money by the transferee to the partnership under section 752(a).

e. Thus, a donor, who makes a donative transfer of an interest in a partnership that has nonrecourse partnership liabilities, will be treated as having been relieved of partnership liabilities (the portion associated with the donated interest) and as having received amounts realized. Consider the Tax Court opinion in *Lipnick v. Commissioner*,[113] which dealt with the issue of the deductibility of certain interest expenses after the death of a partner. During the lifetime of the partner (the father), the partnership incurred partnership debt and made debt-financed distributions (discussed later in these materials) to the partner. During lifetime, the father made gifts of the partnership interests and at death, bequeathed partnership interests to his son. The issue was the treatment and deductibility of the interest expenses that were passed out of the partnership to the son. As to the lifetime gifts the Tax Court writes, "By gratuitously

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[109] § 752(d).

[110] Alternatively, if section 752(d) is not applicable, section 752(b) could be applied to the gratuitous transfer. The result thereunder would be similar, but not exactly the same as applying section 752(d) to the transfer. Section 752(b) treats any decrease in a partner's share of partnership liabilities as a distribution of money to the partner. As discussed in more detail later, money distributions are applied first to reduce the outside basis under section 733, and any money distributions in excess of outside basis will be treated as a capital asset under section 731(a) and 741. As a result, section 734(b) inside basis adjustments may be required.

[111] *See* Treas. Reg. §§ 1.1001-2(a)(1), 1.1001-2(a)(4), 1.1001-2(c), Ex. 3 and 4. *See also* Rev. Rul. 75-194, 1975-1 C.B. 80 (charitable contribution of a partnership interest that carried partnership liabilities).

[112] T.D. 7741, 1981-1 C.B. 430. *See also* § 761(e)(3) which provides, in pertinent part, "Except as otherwise provided in regulations, for purposes of—…any other provision of this subchapter specified in regulations prescribed by the Secretary, any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange."

[113] *Lipnick v. Commissioner*, 153 T.C. 1 (2019).

transferring to [the father] his partnership interests in [the partnerships], [the father] was relieved of his shares of the partnership liabilities represented by the … loans. On his 2011 Federal income tax return, he treated the nonrecourse partnership liabilities of which he was relieved as "amounts realized" on the transfers."[114] The Tax Court held (in part) that the son "did not receive the proceeds of any debt-financed distributions and did not use partnership distributions to acquire property held for investment. Rather, he is deemed to have made a debt-financed acquisition of the partnership interests he acquired by gift and bequest, and the associated interest expense is allocated among the assets of the partnerships."[115]

f. If partnership liabilities are treated as amounts realized under section 752(d) in a donative transfer, the transaction is bifurcated into a sale to the extent of the liability and a gift of the net equity of the partnership interest. If the partnership liabilities exceed the donor's outside basis of the partnership interest, gain will be recognized to the extent of the liability. Generally, the donor's gain will be treated as capital gain under section 741, unless section 751(a) applies.

g. In the context of donative transfer to charity (bargain sale to charity), section 1011(b), with respect to allocating the outside basis of the partnership interest, provides "the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property."[116] In contrast to section 1011(b), the Treasury Regulations[117] allow the donor to offset all of the outside basis of the transferred partnership interest (as determined under Revenue Ruling 84-53, as discussed above, if it is less than all of the donor's interest in the partnership) against the amount realized.

h. As discussed below, if section 752(d) applies to a transfer and gain is recognized, it may give rise to an inside basis adjustment under section 743(b) if there is a section 754 election in effect or as may be mandated, as discussed below.

> **Example:** AB Partnership has two equal partners. A and B jointly owned Capital Asset A and Capital Asset B, in equal shares. A and B contribute Capital Asset A and Capital Asset B when each property had an adjusted basis of $10x and a fair market value of $100x.
>
> A few years after the contributions, AB Partnership borrows $100x on a nonrecourse basis, collateralizing the assets of the partnership. The loan proceeds are distributed tax free to A and B equally because each of their outside bases were increased equally by the loan ($50x each) and then reduced by the distribution of the proceeds of the nonrecourse loan (-$50x each). Each of their capital accounts is, however, reduced by the amount of the distribution (-$50x each). Under the partnership agreement, A and B share the $100x of nonrecourse liabilities equally.

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[114] *Id.* at 3. The Tax Court cites Treas. Reg. §§ 1.752-1(h) and 1.1001-2(a)(4)(v).

[115] *Id.* at 1. *See also* Monte A. Jackel, *Death as a Disposition Redux*, Tax Notes Federal, Tax Notes Federal (Oct. 7, 2019). The author posits that in the *Lipnick* case, the IRS and the court failed to address, among other things, that death itself is a "disposition" under section 1001, and this disposition (death) causes the excess of debt over tax basis immediately before death to be taxed to the decedent on his last income tax return.

[116] § 1011(b).

[117] "Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For the determination of basis of property in the hands of the transferee, see § 1.1015-4. For the allocation of the adjusted basis of property in the case of a bargain sale to a charitable organization, see § 1.1011-2." Treas. Reg. § 1.1001-1(e)(1)

A is planning to make a gift to A's child, C. Prior to the gift, the partnership balance sheet is, as follows:

AB Partnership Balance Sheet					
Assets			**Liabilities**		
	Tax Basis	Fair Market Value			Fair Market Value
Capital Asset A	$10x	$100x	Nonrecourse Liabilities		$100x
Capital Asset B	$10x	$100x	**Capital Account**		
				Outside Basis	Capital Account
			A	$10x	$50x
			B	$10x	$50x
Total	**$20x**	**$200x**	**Total**	**$20x**	**$100x**

A gifts his or her entire 50% interest in AB Partnership to C. Under section 752(d), A's $50x share of partnership liabilities is treated as an amount realized when the gift to C is made, and A will recognize $40x in capital gain. As a result, C's outside basis in the gifted (part gift/part sale) partnership interest will be $50x (cost basis to extent of debt in excess of basis and carryover basis for the gift portion), as follows:

AB Partnership (After Gift) Balance Sheet					
Assets			**Liabilities**		
	Tax Basis	Fair Market Value			Fair Market Value
Capital Asset A	$10x	$100x	Nonrecourse Liabilities		$100x
Capital Asset B	$10x	$100x	**Capital Account**		
				Outside Basis	Capital Account
			C	$50x	$50x
			B	$10x	$50x
Total	**$20x**	**$200x**	**Total**	**$60x**	**$100x**

If AB Partnership makes a section 754 election in the year of the gift, the inside basis of the partnership assets will be adjusted under section 743(b), for the benefit of C only. The inside basis adjustment under section 743 and the allocation of the adjustment among the partnership assets under section 755 are discussed in detail below. As a result, the inside bases of Capital Assets A and B will be increased, notionally for the benefit of C, as follows:

AB Partnership (After Gift and Section 754 Election) Balance Sheet					
Assets			**Liabilities**		
	Tax Basis	Fair Market Value			Fair Market Value
Capital Asset A	$30x (+$20x)	$100x	Nonrecourse Liabilities		$100x
Capital Asset B	$30x (+$20x)	$100x	**Capital Account**		
				Outside Basis	Capital Account
			C	$50x	$50x
			B	$10x	$50x
Total	**$60x (+$40x)**	**$200x**	**Total**	**$60x**	**$100x**

3. Transfers of Interests in a Partnership Holding an Installment Obligation

a. Section 453B(a) of the Code provides if (i) an installment obligation is satisfied for other than its face value, or (ii) distributed, transmitted, sold, or otherwise disposed of, then gain or loss will be recognized. In Revenue Ruling 60-352,[118] dealing with a charitable contribution of an interest in a partnership holding installment obligations, the IRS took the position that the transaction should be fragmented into a transfer of a partnership interest and a transfer of an "appurtenant" right to share in "unrealized partnership income reflected in installment obligations."[119] According to the ruling, the transfer of the appurtenant interest in installment obligations constitutes a "disposition" of the obligations under section 453B(a). The ruling dealt with an installment obligation that represented unrealized ordinary income.[120]

b. The transfer of an installment obligation due to the death of the holder of the installment obligation (installment note) is not considered a taxable disposition.[121] The installment obligation (the remaining unrealized gain of the obligation) is considered IRD.[122] As a result, there is no step-up in basis under section 1014 of the Code, and the unrealized gain and interest will be taxable to the estate and the beneficiaries as payments are received by them.[123] This treatment is in agreement with the adjustment to outside basis on a transfer of a partnership interest that is entitled to a basis adjustment at death under section 1014, as discussed below. On the other hand, if the partnership interest is transferred to an IDGT, where there is no section 1014 adjustment (as discussed blow), then it seems that there will be a deemed taxable disposition of the installment obligation under section 453B (taxable to the decedent-grantor).

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[118] Rev. Rul. 60-352, 1960-2 C.B. 208.

[119] *Id.*

[120] *See also* GCM 35921 (July 29, 1974).

[121] § 453B(c).

[122] *See* § 691(a),

[123] §§ 1014(c), 691(a)(4) and Treas. Reg. § 1.691(a)-5(a).

F. Transfers Entitled to an Outside Basis Adjustment at Death

1. Generally

a. If an individual partner dies owning a partnership interest, the estate's outside basis in the partnership will equal the fair market value of the partnership interest for estate tax purposes (which is net of partnership liabilities), plus the estate's share of partnership liabilities, minus any value attributed to items of income in respect of a decedent (IRD) owned by the partnership. The Treasury Regulations provide, "The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706-1 and paragraph (b) of § 1.753-1) under section 691."[124]

b. Section 691(e) provides, "For application of this section to income in respect of a deceased partner, see §753." This language implies that section 753 is the exclusive rule for IRD with respect to a deceased partner. In turn, section 753 provides, "The amount includible in the gross 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."[125] Because section 753 narrowly applies only to amounts includible under section 736(a) (payments for unrealized receivables and goodwill made to a retiring partner or a deceased partner's successor in interest), some have argued that a deceased partner will have no IRD except for section 736(a) amounts. This assertion has been rejected by the courts[126] and goes against the Treasury Regulations that have been promulgated since the enactment of section 753 in 1954.

c. Thus, the basis adjustment at death under section 1014 can be illustrated as follows:

FMV of Partnership Interest
(Net of Partnership Liabilities)
(Including Valuation Discounts)

INCREASED BY

Share of Partnership Liabilities

DECREASED BY

Value Attributable to IRD Items

d. Because only the net equity value (net of partnership liabilities) is included in the gross estate for estate tax purpose, but the "step-up" in basis is grossed up to include the estate's share of partnership liabilities, one of the ways to leverage the "step-up" in basis prior to the death of a partner is to borrow at the partnership level and distribute the proceeds of the loan to the partners (often referred to as a "refinancing" in the commercial real property business). The procurement of the loan and the subsequent distribution of the proceeds should (assuming the partnership liability is nonrecourse) be a tax-free

[124] Treas. Reg. § 1.742-1.

[125] § 753.

[126] *George Edward Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), *aff'd* 444 F.2d 90 (8th Cir. 1971) *acq.* 1970-2 C.B. [page unknown], and *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972), *aff'g* T.C. Memo. 1969-279.

distribution.[127] In order to take advantage of this "step-up" in basis on the partnership interest, the partner must engage in another step to transfer the loan proceeds out of the gross estate. This second step would not necessarily be needed in the context of nonresident alien partners because often a basis adjustment under section 1014 is available without any U.S. estate tax inclusion.[128]

e. As discussed later in these materials, unless a section 754 election applies, no adjustment is made to the tax basis of the partnership property as a result of the partner's death. The lack of an inside basis adjustment puts the estate (or the successor in interest) at risk of being taxed on unrealized gain in the partnership at the time of the decedent's death.

f. When a decedent passes away owning an asset (like a partnership interest) that has an adjusted (outside) basis greater than its fair market value, it will result in a "step-down" in tax basis to fair market value under section 1014. This could be due to valuation discounts or due to partnership assets with inside bases that are greater than their fair market value. For that reason, the common advice provides that prior to death, taxpayers should recognize any unrealized losses. These losses can offset any gains that the taxpayers will recognize, even if that is on a decedent's last income tax return. Unfortunately, individual taxpayers, estates, and trusts may not carryback capital losses to offset gains in previous taxable years.[129] Further, the IRS has held that capital losses (and carryovers of the same) are only deductible by the taxpayer who sustained the loss.[130] If spouses sell securities or other capital assets held jointly at a loss in the year of death of one of the spouses, then half of the loss can be allocated to the surviving spouse and can be carried forward.[131] If the loss is attributable only to the decedent spouse, any capital loss carryforwards, not otherwise offset by gains on the last return, are lost. As such, taxpayers should be vigilant to recognize losses as soon as possible and offset those losses by recognizing gain on assets that are owned by the taxpayer and the taxpayer's IDGTs.

2. Discounts, Debt, and IRD

a. Section 1.742-1 of the Treasury Regulations provides, in step format, the following methodology to determine the basis adjustment to a partnership interest upon the death of a partner: "The basis of a partnership interest acquired from a decedent is

- the fair market value of the interest at the date of his death or at the alternate valuation date,

- increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and

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[127] The Treasury Regulations provide minimum gain attributable to the proceeds of nonrecourse debt that are distributed to the partners is allocated to those partners who receive the distributions. Treas. Reg. § 1.704-2(g)(1)(i).

[128] Rev. Rul. 84-139, 1984-2 C.B. 168 (real property owned by a nonresident alien and not subject to U.S. estate tax will take a basis equal to its fair market value) and PLR 201245006 (assets held in a foreign revocable trust will receive a basis adjustment at death under section 1014(b)(1) of the Code even though the assets are not subject to U.S. estate tax). However, it is likely the IRS mistakenly cited (b)(1) in PLR 201245006 as the operative subsection for the basis adjustment at death.

[129] *See* § 1212.

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

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

- reduced to the extent that such value is attributable to items constituting income in respect of a decedent."

b. Because the basis adjustment at death is based, in part, on the fair market value of the partnership interest, careful consideration should be given to any applicable valuation discounts and the amount of partnership liabilities acquired by the successor in interest (i.e., estate). From an income tax perspective, each dollar of valuation discount (applied to the net equity value of the partnership interest) will be a dollar reduction in the basis adjustment at death. As discussed later in these materials, a valuation discount can also cause a reduction in inside basis under section 743(b), particularly if a section 754 election is in place.

c. In contrast, each dollar of partnership liability first reduces the fair market value of the partnership interest (because the fair market value is net of partnership liabilities), but then each dollar of partnership liability allocated to the successor transferee of the partnership interest (under the terms of the partnership agreement) will be a dollar increase in the basis adjustment at death.

d. Although Treasury Regulation section 1.742-1 is not explicit, presumably the reduction for partnership liabilities in step one of the foregoing calculation is applicable only to the decedent's share of partnership liabilities. It is clear that the addition in step two of the calculation only applies to the share of partnership liabilities that are borne by the estate (or other successor in interest) as a result of the transfer of the partnership interest. One can imagine a situation where the decedent partner had agreed to be solely responsible for a disproportionate amount of the liabilities of the partnership (recourse as to the decedent partner) but, after the death of the partner, the liabilities become nonrecourse.[132] In such instance, the reduction in step one would be greater than the increase in step two because the estate's share of liabilities will generally be less than the decedent's prior to death.

e. How IRD affects the basis adjustment is open to interpretation, unfortunately, because the Treasury Regulations do not contain any examples of how to determine "the extent that such value is attributable." There are at least four different interpretations:

(1) Interpretation One (reduction is equal to the full value of the IRD): After calculating the first two steps (fair market value of the interest net of liabilities plus the successor in interest's share of liabilities), this value is reduced by the gross fair market value of the decedent's share of any IRD items in the partnership. The theoretical problem with this interpretation is that a full dollar-for-dollar reduction for all of the IRD does not take into account that the value of the partnership interest attributable to the IRD carried a valuation deduction (in the first step).

(2) Interpretation Two (reduction is equal to a proportionate amount of the value determined after step two): After calculating the first two steps (fair market value of the interest net of liabilities plus the estate's share of liabilities), the resulting value is reduced by the proportionate value of IRD in comparison to the fair market value of all the partnership assets. In other words, if the partnership assets consisted of 30% IRD assets and 70% other assets, the value (after valuation discounts and partnership liabilities are accounted for) should be reduced by 30%. That is certainly how the Treasury Regulations seems to read.

[132] For example, often lenders will provide that if an individual who is personally liable for a loan dies, the individual's surviving spouse will automatically be personally liable for such loan, whether or not the surviving spouse is a partner of the partnership. If there is no surviving spouse, the loan becomes due and payable by the decedent's estate (deductible for estate tax purposes under section 2053), which means the increase in step two will be less than the reduction in step one.

(3) Interpretation Three (reduction is equal to a proportionate amount of the value determined after step one): When the Treasury Regulation states, "the extent that such value is attributable…," the words "such value" refers to the "fair market value of the interest," the value in step one. It does not include the addition of the successor's share of partnership liabilities. The theoretical reason this is more accurate than the previous interpretation is that Interpretation Two above reduces the impact of partnership liabilities by a proportionate amount based on the value of the IRD in comparison to the fair market value of all of the partnership assets. There is no theoretical reason to reduce outside basis if the gross amount of the partnership liabilities are, in fact, transferred to the estate (or successor in interest). As such, in this interpretation, the reduction in step three is equal to the value in step one (fair market value of the partnership interest) reduced by the proportionate value of IRD in comparison to the fair market value of all the partnership assets.

(4) Interpretation Four (reduction is equal to the discounted value of all IRD): After calculating the first two steps, this value is reduced by the discounted fair market value of the decedent's share of any IRD items in the partnership. For example, if the partnership interest is subject to a 25% valuation discount, then the reduction would be equal to 75% of the gross fair market value of the IRD.

f. The following example illustrates the differences between the four interpretations.

Example: D is a decedent that died owning a partnership interest. On the date of death, the partnership interest had the following outside basis, capital account, and share of the partnership's assets and liabilities, including D's share of the partnership's inside basis and unrealized gain (including in any section 704(c) property):

Decedent Partner's Share Partnership Assets & Liabilities					
Assets			**Liabilities**		
	Tax Basis	Book Value			Book Value
Capital Assets	$50x	$150x	Nonrecourse Liabilities		$100x
IRD Assets	$0x	$50x	**Capital Account**		
				Outside Basis	Capital Account
			Estate of D	$50x	$100x
Total	**$50x**	**$200x**	**Total**	**$40x**	**$200x**

Assume the partnership interest is entitled to a 30% valuation to liquidation value (capital account balance) and such value is the fair market value for inclusion in the gross estate of D. As a result, in step one, the fair market value is the gross value of the partnership assets $200x, less partnership liabilities of -$100x, reduced by a 30% valuation discount of $30x. The fair market value of the interest in this example is $70x. In step two, the estate's share of partnership liabilities are added to the value in this step, resulting in a value of $170x.

Interpretation One (reduction is equal to the full value of the IRD) would result in an outside basis for the partnership interest equal to $120x, determined by reducing the 170x of maximum basis adjustment (assuming no IRD) by the $50x of IRD. As noted above, the theoretical problem with this interpretation is that the full dollar-for-dollar reduction for all the IRD does not take into account the fact that the value of the partnership interest attributable to the IRD carried a valuation deduction (in the first step).

Interpretation Two (reduction is equal to a proportionate amount of the value determined after step two) would result in an outside basis for the partnership equal to $127.5x. It is determined as follows. IRD constitutes 25% of the total value of the partnership assets ($50x of IRD divided by $200x of total partnership assets). The value in step two ($170x) is reduced by $42.5x (25% of $170x) to $127.5x.

Interpretation Three (reduction is equal to a proportionate amount of the value determined after step one) would result in an outside basis for the partnership interest equal to $152.5x, determined as follows. As noted above IRD constitutes 25% of the partnership assets. The reduction in step three is -$17.5x, which is 25% of the value in step one ($70x). The three steps are combined as follows: $70x (FMV of interest) plus $100x (share of liabilities) less $17.5x (reduction for IRD) equals $152.5x outside basis adjustment to the partnership interest.

Interpretation Four (reduction is equal to the discounted value of all IRD) would result in an outside basis for the partnership interest equal to $135x, determined by reducing the 170x of maximum basis adjustment (assuming no IRD) by the discounted value of the IRD which is $35x (the valuation discount is $15x [30% of $50x]). The three steps are combined as follows: $70x (FMV of interest) plus $100x (share of liabilities) less $35x (reduction for IRD) equals $135x outside basis adjustment to the partnership interest.

If the partnership has a section 754 election in place, the inside basis adjustment will increase the inside basis of the partnership assets by the excess of the estate's outside basis over the estate's share of inside basis. As discussed later in these materials, the estate's share of inside basis is equal to previously taxed capital plus its share of partnership liabilities. The methodology for calculating previously taxed capital involves a hypothetical liquidation of the partnership, which results, in this example in previously taxed capital being equal to $-50x.[133] The results, for each of the three interpretations, however, are summarized in the following table:

[133] As discussed later in the materials, a partner's previously taxed capital is the amount of cash the partner (capital account of $100x) would receive upon a liquidation of the partnership following a hypothetical sale of all the partnership assets in a fully taxable transaction *decreased*, in this case, by the amount of gain that would be allocated to the partner (-$150x). Previously taxed capital is thus -$50x, making the partner's share of inside basis +$50x when partnership liabilities are added to that figure.

Interpretation	Previously Taxed Capital	Share of Partnership Liabilities	Share of Inside Basis	§ 1.742-1 Outside Basis	§ 743(b) Amount
One	-50x	$100x	$50x	$120x	$70x
Two	-50x	$100x	$50x	$127.5x	$77.5
Three	-50x	$100x	$50x	$152.5x	$102.5x
Four	-50x	$100x	$50x	$135x	$85x

Under the Treasury Regulations, none of the inside basis adjustment can be allocated to IRD assets.[134] Each of the methods would result in an adjusted tax basis to the capital assets, as follows:

Interpretation	Basis Before Adjustment	§ 743(b) Adjustment	Resulting Basis	Fair Market Value
One	50x	$70x	$120x	$150x
Two	50x	$77.5	$127.5x	$150x
Three	50x	$102.5x	$152.5x	$150x
Four	50x	$85x	$135x	$150x

From a theoretical standpoint, the resulting basis to the capital assets should actually be $105x. Consider that if D had died owning: (i) capital asset with a basis of $50x and value of $150x; and (ii) IRD assets with a basis of $0x and value of $50x. Imagine that these assets are subject to a 30% valuation discount. The IRD assets will not get a basis adjustment at death, which leaves the capital assets which will have a fair market value of $105x after the 30% discount (-$45x). As such, in this scenario, the capital assets would have its basis adjusted to $105x.

The surprising result, under section 1.742-1 of the Treasury Regulations, regardless of the interpretation chosen, is that the capital assets end up with a higher adjusted basis after the section 743(b) adjustment that those assets would have if the assets were held outside of the partnership (but subject to the same valuation discount). In fact, in interpretation three (proportionate reduction due to IRD after step one), the capital assets end up with an adjusted basis in excess of the fair market value.

g. It is unclear which one the foregoing interpretations is correct. Part of the disconnect may come from the outside basis reduction for IRD being based on values, specifically upon "the extent that such value is attributable" to items of IRD. In contrast, as discussed later, the inside basis adjustment under section 743(b) is calculated, in part, by using a hypothetical sale approach which is then adjusted by the amount of gain or loss that would be allocated to the partner. In the foregoing example, the capital assets represent 75% of the value but the unrealized gain in the capital asset represent 67% of the total unrealized gain. The IRD assets represent 25% of the value but the unrealized gain in the IRD assets represent 33% of the total unrealized gain.

h. If the transfer at death is not entitled to a basis adjustment under section 1014 (i.e., a deemed transfer from an IDGT to a taxable non-grantor trust caused by the death of the grantor), then the transfer may still cause the transferor (the grantor) to recognize gain in the same way that a

[134] Treas. Reg. § 1.755-1(b)(4)

gratuitous transfer of a partnership interest that carries a greater share of partnership liabilities than its outside basis under section 752(d).

3. Eliminating Valuation Discounts

a. Generally

(1) A common "free-base" situation occurs when the first spouse passes away, and assets are transferred to or for the benefit of the surviving spouse in a transfer that qualifies for the marital deduction under section 2056. In community property states, the "step-up" in basis will also apply to the assets held by the surviving spouse. Clearly, for income tax purposes, a higher valuation is preferable to a lower valuation. As such, consideration should be given to when valuation discounts should be created and when they should be removed. For example, when both spouses are alive, it is sensible to avoid valuation discounts, and if the assets that would be includible in the surviving spouse's estate are significantly above the basic exclusion amount (including any ported amount), then valuation discounts will likely save more in estate taxes than the income tax savings from the subsequent "step-up" at the surviving spouse's estate. If a quick succession of deaths is a worry, practitioners should be prepared to layer valuation discounts immediately after the first death, so post-mortem estate planning might include the estate creating family limited partnerships prior to the complete settlement of the estate.

(2) Where assets have been divided among generations to create discounts, consideration should be given to undoing those arrangements if the effect is to depress the value of an estate below the basic exclusion amount in order to increase the income tax basis of the assets under section 1014.

(3) Family limited partnerships or other entities that create valuation discounts could be dissolved or restated to allow the parties to the entity to withdraw for fair value or to remove restrictions on transferability.

(a) An option could be given to a parent allowing the sale of the parent's interest to a child or children for undiscounted fair market value at death. Giving such an option to a parent would be a gift unless accompanied by adequate and full consideration.

(b) If undivided interests in property are owned, family control agreements could be entered into that require all generations to consent to the sale of the property as one tract, and join in paying the expenses of a sale, if any one owner wanted to sell. Quite obviously such agreements may be contrary to other estate planning or ownership goals of the family.

(4) The ability of the IRS to ignore provisions of an agreement that increase the value of assets in the hands of a parent, but not in the hands of a child, is uncertain. By its literal terms section 2703 applies only to provisions that reduce value and to restrictions on the right to sell or use property. To illustrate, in *Estate of James A. Elkins, Jr., et al. v. Commissioner*,[135] the Tax Court applied section 2703 to ignore a family co-tenancy agreement requiring all owners of fractional interests in art to agree before the art could be sold. The purpose of that agreement was to limit the marketability of each fractional interest. But what might the effect on value be of an agreement which provided, instead, that any fractional owner could compel the sale of the entire asset? Similarly, a provision that allows a partner to put his or her partnership interest at death for fair market value would seem to be outside the scope of the section. In many instances amending old agreements to include such provisions will be more likely to

[135] 140 T.C. 86 (2013), *rev'd*, *Estate of James A. Elkins, Jr. v. Commissioner*, 767 F.3d 443 (5th Cir. 2014).

create gifts from the younger owners to the older owners than would terminating an old agreement and creating a new one.

b. Conversion to General Partnership with Disregarded Entities

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

(a) Section 2704(b) of the Code will disregard certain "applicable restrictions" on the ability of the partnership to liquidate. However, an exception exists for "any restriction imposed . . . by any Federal or State law."[136] Since the effective date of section 2704 of the Code, the vast majority (maybe all) of the states have amended their limited partnership and limited liability company statutes to provide for significant restrictions on an owner's ability to liquidate his or her ownership interest in those entities, thereby rendering section 2704(b) inapplicable.[137] Proposed Treasury Regulations issued in August 2016 would have enabled the IRS to disregard certain features of applicable state law that limited the application of section 2704. Those proposed regulations were roundly criticized, ordered to be withdrawn in their entirety,[138] and officially withdrawn as of October 20, 2017.[139]

(b) General partnership statutes, on the other hand, provide much more liberal provisions for liquidation and dissolution of a partnership and for the withdrawal of a partner. Consider the following: (i) section 801 of the Uniform Partnership Act (UPA)[140] provides in a partnership at will, dissolution occurs upon a person's express will to withdraw; (ii) under section 601(1) of the UPA, a person is dissociated as a partner when the partnership has notice of the person's express will to withdraw as a partner; (iii) section 602(a) of the UPA points out that a person has the power to dissociate as a partner at any time, rightfully or wrongfully; and (iv) sections 701(a) and (b) of the UPA provide, upon dissociation, the partnership is required to purchase the person's interest in the partnership for a buyout price that is the *greater* of liquidation value or the value based on a sale of the entire business as a going concern without the person.[141]

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[136] § 2704(b)(3)(B).

[137] *See, e.g., Kerr v. Commissioner*, 113 T.C. 449 (1999) (The Tax Court held section 2704(b) of the Code was not applicable because the partnership agreement was no more restrictive than § 8.01 of the Texas Revised Limited Partnership Act, which generally provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the agreement or upon the written consent of the partners.), *aff'd* 292 F.3d 490 (5th Cir. 2002) (The Fifth Circuit affirmed the decision that section 2704(b) of the Code is inapplicable under section 2704(b)(2)(B)(i) of the Code. Section 2704(b)(2)(B)(i) provides that "the transferor or any member of the transferor's family, either alone or collectively, must have the right to remove the restriction" immediately after the transfer for the restriction to be one that would be disregarded. In the case, the University of Texas was a partner in the partnership.).

[138] Steven T. Mnuchin, Secretary of Treasury, *Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Executive Order 13789*, 2018-03004 (Rev. 1), (October 2, 2017) [https://www.treasury.gov/press-center/press-releases/Documents/2018-03004_Tax_EO_report.pdf].

[139] FR Doc. 2017-22776, 82 Fed. Reg. 48779.

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

[141] The comment to section 701(b) of the UPA provides, "Liquidation value is not intended to mean distress sale value. Under general principles of valuation, the hypothetical selling price in either case should be the price that a willing and informed buyer would pay a willing and informed seller, with neither being under any compulsion to deal. The notion of a minority discount in determining the buyout price is negated by valuing the business as a going concern.

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

(2) Where retaining limited liability of a partner is important, the partner should utilize a wholly-owned limited liability company that is treated as a disregarded entity for Federal tax purposes.[142] The use of disregarded entities is discussed in more detail later in these materials. In this instance, the partner would first contribute his or her limited partnership or limited liability company interest into the disregarded entity and then the limited partnership or limited liability company would "convert" to a general partnership. The conversion can be accomplished under a conversion power,[143] interest exchange[144] and dissolution, or other merger transaction.

(3) Because all of the limited partners and limited liability company members retain the same proportionate interest in the resulting entity, there is no gift for transfer tax purposes because of the "vertical slice" exception to section 2701 of the Code.[145]

G. Conversion of Grantor Trust to Non-Grantor Trust

1. Introduction

a. When grantor trust status is terminated or when a non-grantor trust becomes a grantor trust, the obvious end result is that the "owner" of the trust asset for Federal income tax purposes changes. When grantor trust is terminated, the trust becomes a separate taxable entity (non-grantor trust), and when a non-grantor trust becomes a grantor trust, the grantor (or someone other than the grantor under section 678 of the Code) becomes the owner of the trust's assets for Federal income tax purposes. From an income tax perspective, how does that change in ownership occur?

b. If the change in ownership is treated like a gift, then as previously discussed, the receipt of the trust property is not income to the recipient, and the property will have a carryover basis under section 1015 of the Code. If the change in ownership is caused by the death of the grantor, then like bequests or other transfers as death, do the trust assets get a basis adjustment under section 1014 of the Code? Could the change in ownership be considered a taxable sale or exchange, with gain and possibly loss recognition?[146] Or could this transfer of ownership be akin to a tax-free exchange? If the change in ownership is not a taxable event, if debt (including of partnership liabilities) is in excess of basis, do *Crane* and section 752(d) require gain recognition?

Other discounts, such as for a lack of marketability or the loss of a key partner, maybe appropriate, however. For a case applying the concept, see *Fotouhi v. Mansdorf*, 427 B.R. 798, 803–05 (Bankr. N.D. Cal. 2010)."

[142] A single owner entity that has not elected to be classified as an association (corporation). *See* § 7701 and Treas. Reg. §§ 301.7701-1(a), -2(c)(2), -3(b)(1)(ii).

[143] *See* § 1141(a)(1) of the UPA

[144] *See* § 1131(a) of the UPA.

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

[146] *But see* § 267 (disallowance of losses form sales or exchanges between related persons, applies to sales or exchanges of partnership interests).

2. Conversion During the Grantor's Lifetime

a. In Revenue Ruling 77-402,[147] the IRS held that when grantor trust is terminated during the grantor's lifetime, the grantor is deemed to have transferred the trust property to a separate taxable entity. If the transferred property is subject to debt and the debt is in excess of basis, then the grantor, as the transferor, will recognize gain. In the ruling, A, an individual, created a T, an irrevocable trust (IDGT for the benefit of A's descendants) which is a grantor trust as to the entire trust due to certain retained powers. A contributed some funds to T, and the trustee used those funds to purchase a partnership interest in P, a partnership with a principal activity of investing in real property, using both recourse and nonrecourse financing. P elected accelerated depreciation. The resulting deduction were allocated to the partners of P, including T and in turn, deducted on A's income tax returns.

b. When the adjusted basis of the partnership interest was nearly zero (deductions and other losses are limited to the amount basis in the partnership interests) and the real property had started generating net income, A, as grantor, renounced the powers that made T a grantor trust. The IRS ruled, "at the time A renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust, with the result that A was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, A is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor, A."[148]

c. When a partner transfers an interest in a partnership and the transferor's share of partnership liabilities are reduced or eliminated, the transferor is treated as having sold the partnership interest for an amount equal to the amount of reduced or eliminated liabilities. The IRS thus concluded, "A realized an amount equal to the share of partnership liabilities that existed immediately before T converted from grantor to non-grantor status for Federal income tax purposes. The gain or loss realized by A is the difference between the amount realized from the reduction of the share of P's liabilities and the adjusted basis in the partnership interest … immediately prior to the change in T's tax status."[149] The ruling went on to say, the result would be the same if the termination of grantor trust status occurred due to the expiration or lapse of the powers or due to the exercise, release, renunciation, expiration or lapse of certain powers held by party other than the grantor.

d. In 1980, the IRS issued section 1.1001-2 of the Treasury Regulations which addressed the discharge of liabilities in determining gain or loss on a sale, exchange, or other disposition. The Treasury Regulations provide, "the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."[150] In particular, the Treasury Regulations provide the following special rules:[151]

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

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[147] Rev. Rul. 77-402, 1977-2 C.B. 222.

[148] *Id.*

[149] *Id. See also* G.C.M. 37228 for a more detailed discussion of the reasoning supporting the revenue ruling.

[150] Treas. Reg. § 1.1001-2(a)(1).

[151] Treas. Reg. § 1.1001-2(a)(4)(i) through (v).

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

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

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

e. These Treasury Regulations also include an example[152] that is similar to Revenue Ruling 77-402. In the example, C, an individual, creates an irrevocable wholly owned grantor trust. The trustee bought an interest in a partnership. C deducted the distributive share of partnership losses attributable to the partnership interest held by the trust. When the adjusted basis of the partnership interest held by the trust was $1,200, C renounced the grantor trust powers, and the trust then ceased to be a grantor trust. At the time of the renunciation all of the partnership's liabilities are nonrecourse liabilities on which none of the partners have assumed any personal liability. The trust's proportionate share of the partnership liabilities was $11,000. The example concludes when C renounced the grantor trust powers, the trust no longer qualified as a grantor trust, with the result that C was no longer considered to be the owner of the trust and trust property for income tax purposes. Consequently, C was considered to have transferred ownership of the partnership interest to the trust, which was now a separate taxable entity, independent of C. On the transfer, C's share of partnership liabilities ($11,000) was treated as the amount realized by C. C's resulting gain was $9,800 ($11,000 - $1,200).

f. The taxpayers in *Madorin v. Commissioner*[153] challenged the validity of the foregoing example in the Treasury Regulations, essentially taking the position in the *Rothstein v. Commissioner* [154] Bernard Madorin was the grantor of four trusts. The trustee of each of the four trusts had the power to sprinkle income and principal among a class of beneficiaries, and the power to add charitable beneficiaries. The four trusts were, therefore, grantor trusts pursuant to section 674(a) of the Code. The trusts bought limited partnership interests in a limited partnership, which in turn purchased a partnership interest in Saintly Associates. Bernard recognized losses generated by Saintly Associates. When Saintly Associates began generating income, the trustee renounced his power to add beneficiaries and the trusts ceased to be grantor trusts. The grantor argued that he should be treated as the owner of the trust only to attribute to him items of income, deductions, and credits (the *Rothstein* ruling). The IRS disagreed with the taxpayer and assessed a deficiency. Basing its position on the aforementioned example in the Treasury Regulations, the IRS contended that the grantor was the owner of the partnership interests and when the trusts ceased to be grantor trusts there was a disposition of the trusts' assets (the partnership interests) on which gain would be recognized to the extent that the underlying debt from which the trust was released exceeded the taxpayer's basis in the partnership interests. The Tax Court ruled for the IRS. In coming to that conclusion, the court stated, "Absent a clear and unambiguous legislative directive in this matter, limiting the usage of the word "owner," we will apply the usual, ordinary, and everyday meaning of the word."[155]

[152] Treas. Reg. § 1.1001-2(c), Ex. 5.

[153] *Madorin v. Commissioner*, 84 T.C. 667 (1985).

[154] 735 F.2d. 704 (2d. Cir. 1984).

[155] *Id.* at 673.

g. Given the foregoing precedents, the termination of grantor trust status during the grantor's lifetime is treated as a transfer by the grantor of the trust's assets to the trust (now a separate taxpayer) in exchange for any consideration the trust may give to the grantor. The foregoing consideration will include any discharge of liabilities of the grantor that results from such transfer. In particular, if nonrecourse debt encumbers the trust property and such debt exceeds basis, then grantor will recognize gain on the deemed transfer. If the property is not encumbered with debt, the transfer is akin or may actually be a gift for income tax purposes. The result is that the trust will not realize income when the deemed transfer occurs, no sale or exchange occurs, and the trust will take a basis in the property as determined under section 1015 of the Code.

3. Conversion Due to the Grantor's Death

a. If grantor trust status is terminated due to the grantor's death, clearly the grantor-decedent is no longer considered the owner of the trust property for income tax purposes. The IRS has ruled that upon the death of the grantor, the trust springs into existence as a separate taxpayer.[156] As such, the trust assets are deemed to be transferred to the new taxpayer, but it's not clear what type of transfer it is, and whether, under some circumstances, it could be considered a taxable event.

b. Notably, while acknowledging there is no Code section that explicitly addresses the issue, some commentators have asserted categorically that gain or loss is not recognized by a transfer in connection with the death of the owner.[157] They cite *Crane*, *Diedrich*, and section 1.1001-2 of the Treasury Regulations in support of the claim that dispositions of property with debt in excess of basis only results in gain recognition with lifetime transfers, although they do *not*, collectively or individually, say that. This view is exacerbated by an IRS ruling that gratuitously stated "death … is generally not treated as an income tax event,"[158] even though the ruling itself was not addressing the income tax consequences of a conversion of a trust's status due to the death of any individual. In furtherance of this notion that a transfer at death is never a recognition event, some commentators have pointed to Revenue Ruling 73-183.[159] In the ruling, a taxpayer purchased stock at $30 per share and later died when the stock had a fair market value of $20 per share. Under section 1014 of the Code, the stock's basis was adjusted to $20 per shares. Notwithstanding the foregoing, the estate of the taxpayer sought guidance on whether a loss is recognized on the taxpayer's final income tax return as a result of the transfer of the stock to the estate. The ruling held that no gain or loss is recognized when stock is transferred from the decedent to the estate, whether the adjusted basis prior to death was less than or in excess of the fair market value on the date of death. These arguments ignore the fact that most transfers at death result in a basis adjustment to fair market value under section 1014 of the Code. If a decedent dies with appreciated property, subject to a nonrecourse debt that is in excess of the property's tax basis prior to death, when the property is "stepped-up" to fair market value, the property no longer has debt in excess of basis.

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

[157] *See* Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. Tax'n 149 (2002) and Elliott Manning and Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est., Gifts & Tr. J. 3 (1999).

[158] CCA 200923024 (dealing with a conversion from non-grantor to grantor trust status).

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

c. More recently in the footnote of an article,[160] these same commentators have pointed to the language in the opinion in *Estate of Backemeyer v. Commissioner*,[161] in which the Tax Court states, "nonrecognition on death is among the strongest principles inherent in the income tax."[162] However, these commentators fail to mention that the case was not dealing with a deemed transfer at death of assets encumbered by debt. Rather, the case dealt with the "tax benefit rule," the applicability of which relies on the existence (or nonexistence) of a "nonrecognition provision" in the transaction. They also fail to mention that the Tax Court explicitly ruled in the favor of the taxpayer because of the section 1014 step-up in basis. The Tax Court writes, "The sole cause for the allowance of two deductions here is section 1014(a), which steps up the basis of property acquired from a decedent. Were section 1014 not to apply, then Mrs. Backemeyer would have received the farm inputs with a zero basis and therefore been unable to deduct them. We find it unlikely that respondent would have pursued his tax benefit rule argument were that the case."[163]

d. Estates of decedents who died in 2010 could elect to apply the modified carryover basis regime of now repealed section 1022 of the Code, instead of being subject to the estate tax regime that had been reinstated retroactively for that year.[164] Generally, section 1022 of the Code provided that recipients of property from estates that elected out of the estate tax would receive property with a basis equal to the lesser of the adjusted basis of the decedent or the property's fair market value.[165] It provided for certain modifications including the ability to increase the aggregate adjusted basis of estate property up to $1.3 million, [166] with additional increases of up to $3.0 million for property passing to a surviving spouse, outright or to a QTIP trust.[167] The drafters of the Code section clearly understood that if property passes by death but with carryover basis, rather than with a basis adjustment under section 1014 of the Code, gain would be recognized if any property had debt in excess of basis. To that end, they added section 1022(g)(1) which provides, "In determining whether gain is recognized on the acquisition of property from a decedent by a decedent's estate or any beneficiary other than a tax-exempt beneficiary, and from the decedent's estate by any beneficiary other than a tax-exempt beneficiary, and in determining the adjusted basis of such property, liabilities in excess of basis shall be disregarded."[168] What is particularly telling is, as written, if property with debt in excess of basis had passed from the decedent to a tax-exempt beneficiary (i.e., charitable organization), gain would have been recognized.

e. Some have pointed to language in the legislative history of section 1022 in support of the notion that death is not a taxable event. In the general explanation of tax legislation of the Economic Growth and Tax Relief Reconciliation Act of 2001, the Joint Committee on Taxation states, "EGTRRA clarifies that gain is not recognized at the time of death when the estate or heir acquires from

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[160] *See* Mitchell M. Gans and Jonathan G. Blattmachr, *Grantor Trust Assets and Section 1014: New IRS Ruling Doesn't Solve the Problem*, 139 J. of Tax. 16 (2023), fn. 13.

[161] *Estate of Backemeyer v. Commissioner*, 147 T.C. 523 (2016).

[162] *Id.* at 544.

[163] *Id.* at 543-544.

[164] Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). The election out of the estate tax regime is not in the Code. *See* Notice 2011-66, 2011-35 I.R.B. 184, Rev. Proc. 2011-41, 2011-35 I.R.B. 188, and Notice 2011-76, 2011-40 I.R.B. 479.

[165] § 1022(a)(2).

[166] § 1022(b)(2)(B)

[167] § 1022(c)(1).

[168] § 1022(g)(1).

the decedent property subject to a liability that is greater than the decedent's basis in the property. Similarly, no gain is recognized by the estate on the distribution of such property to a beneficiary of the estate by reason of the liability."[169] Similarly, the Senate Finance Committee explanation states the same language as above, but it then goes on to point out, "This rule does not apply if the transfer is from the decedent's estate to a tax-exempt beneficiary, which includes (1) the United States, any State or political subdivision thereof, any U.S. possessions, any Indian tribal government, or any agency or instrumentality of the aforementioned; (2) an organization exempt from tax (other than a farmers' cooperative described in section 521); or (3) any foreign person or entity."[170] They point to the word "clarifies," implying that present law categorically means that death is never a taxable event. This argument ignores the fact that these statements are not contained in the "Present Law" sections of the legislative history, but in the explanation of the legislation or bills that were passed by the relevant legislative bodies.

f. In the mid-1970's, with the 1976 Tax Reform Act,[171] Congress eliminated the "step-up in" basis and enacted a carryover basis regime under predecessor section 1023 of the Code which would have been applied for decedents dying after December 31, 1979. At that time, learned commentators noted that, on the death of the decedent, gain will be recognized upon a transfer of the decedent's property in an amount equal to the difference between basis and liability.[172] In coming to that conclusion they concluded, a "transfer effected at death should not be taxed any differently so far as the decedent transferor is concerned than are inter vivos transfers. Any gain or loss recognized on a transfer at death should be reported on the decedent's final return."[173] The carryover basis regime at death was repealed retroactively in 1980, so it never came into effect.[174] One of the reasons for the repeal was likely the debt in excess of basis issue.

g. The debatable issue at hand does not involve property included in the gross estate of a decedent and which gets a basis adjustment under section 1014 of the Code. There is no question that upon the death of the grantor, property in a revocable living trust, for example, that is "transferred" to a trust that is now a non-grantor trust, even if encumbered by a mortgage that is in excess of its basis, will not be considered a recognition event.[175] That is because of the basis adjustment at death. The issue is what happens when IDGT assets, which are designed to be excluded from the gross estate of the grantor-decedent, are "transferred" to a non-grantor trust. What is the resulting basis of the assets in the IDGT? Is there recognition of gain if the assets are subject to a debt (i.e., partnership interest collateralizing an IDGT installment obligation or transfer of a partnership interest carrying partnership liabilities) that is in excess of the basis of the assets?

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[169] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 107th Congress*, JCS-1-03 (January 24, 2003).

[170] Senate Finance Committee Report, *Technical Explanation of Provisions approved by the Committee on May 15, 2001*, S. Prt 107-30, 107th Cong., 1st Sess. (May 2001).

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

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

[173] *Id*. at 569.

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

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

h. Notwithstanding arguments to the contrary,[176] the IRS recently issued Revenue Ruling 2023-2,[177] holding that there is no basis adjustment under section 1014 to the assets of a trust on the death of an individual "who is the owner of the trust under chapter 1 of the Code (chapter 1) if the trust assets are not includible in the owner's gross estate pursuant to chapter 11 of the Code (chapter 11)."[178] In the ruling, the individual taxpayer established an irrevocable trust and funded it with assets in a transfer that was a completed gift for gift tax purposes. The individual retained a power over the trust that caused him to be treated as its owner for income tax purposes under the grantor trust rules. However, the individual did not hold a power over the trust that would result in the inclusion of the trust's assets in his or her gross estate for transfer tax purposes. By the date of the taxpayer's death, the fair market value of the asset had appreciated. At that time, the trust liabilities did not exceed the basis of the trust assets and neither the individual nor the trust held a note on which the other was the obligor. In coming to the conclusion that the basis of the assets after the death of the individual "is the same as the basis of Asset immediately prior to A's death,"[179] the IRS reasoned the basis of the trust assets are not adjusted under section 1014 because the assets were "not acquired or passed from a decedent as defined in § 1014(b)."[180]

i. Revenue Ruling 2023-2 is in agreement with the conventional view that assets in an IDGT that are not included in the grantor's gross estate will not receive a "step-up" in basis under section 1014. In Chief Counsel Advice 200937028[181] a taxpayer transferred assets into a trust and reserved the power to substitute assets, and the trust assets did not qualify for a basis adjustment under section 1014(b)(1) through (b)(10) of the Code. In the ruling, the Chief Counsel quotes from section 1.1014-1(a) Treasury Regulations: "The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death. . . . Property acquired from the decedent includes, principally . . . property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]" From this the Chief Counsel concludes, "Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9)."[182]

j. The implication of Revenue Ruling 2023-2 with respect to the tax basis of property that is owned by the IDGT is that if the property is not encumbered with debt, the transfer is akin or may actually be a gift for income tax purposes. The result is that the trust will not realize income when the deemed transfer occurs, no sale or exchange occurs, and the trust will take a basis in the property as determined under section 1015 of the Code. A termination of grantor trust status upon the death of the grantor is effectively a transfer of the underlying trust assets, as if the assets had been transferred by gift under section 1015(a) or, alternatively, section 1015(b), as proposed in an excellent article (but which gets

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[176] *See* Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. Tax'n 149 (2002). This is not true for nonresident alien decedents; a basis adjustment is allowed regardless of whether assets are includable in the gross estate. Rev. Rul. 89-139, 1984-2 C.B. 168.

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

[178] *Id.*

[179] *Id.*

[180] *Id.*

[181] CCA 200937028.

[182] *Id.*

to the same result).[183] In that article, the authors argue that section 1015(b) of the Code specifically should apply to determine the basis of assets in IDGTs when termination of grantor trust status is caused by the death of the grantor. Section 1015(b) of the Code provides if property is acquired "by transfer in trust (other than by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer."[184] Thus, if the death of the grantor is not a taxable event for income tax purposes, then the acquired basis is simply the donor's basis prior to death. In addition, if the property secures a nonrecourse debt that is in excess of the property's basis, then gain will be recognized (and the amount of gain will be added to the resulting adjusted basis of the property). The IRS has implied this result already. For example, as discussed above, the IRS ruled that when property transferred to a grantor trust is transferred to the grantor under the terms of the trust instrument at the termination of the trust, its basis is the same as the basis of the property in the hands of the grantor upon the original contribution.[185]

k. Because deemed transfers to IDGTs upon the death of the grantor are not entitled to a basis adjustment under section 1014, there are common situations where gain will be recognized on the death of the grantor even in the absence of liabilities at the partnership level.

> **Example:** Partner A holds a 50% interest in the AB Partnership. AB Partnership owns an appreciated capital asset and no partnership liabilities. Partner A sells the partnership interest to an IDGT in exchange for a $6 million installment obligation. The partnership interest collateralizes the obligation. At the time of the sale, the partnership interest had an outside basis of $2 million and a capital account of $10 million. The difference between the $6 million sale price and the $10 million capital account is due to a 40% valuation discount. The transfer and the exchange are disregarded under Revenue Ruling 85-13. The IDGT pays interest on the installment obligation but does not make any principal payments. A dies, and the IDGT is converted to a taxable non-grantor trust.
>
> There is a deemed transfer of the partnership interest. At that time, the partnership interest collateralized a $6 million debt, but the partnership interest had an outside basis of $2 million. As a result, there is a deemed transfer of an asset (partnership interest) that has debt in excess of basis. There is a part gift, part sale transfer. The amount realized by the grantor is $6 million, resulting in the recognition of $4 million of capital gain.

II. SECTION 743 INSIDE BASIS ADJUSTMENTS

A. Generally

1. The general rule, under section 743(a), provides "the basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754… is in effect with respect to such partnership or unless the partnership has a substantial built-in loss immediately after such transfer."[186] The latter rule for a "substantial built-in-loss" is discussed later in these materials. These types of transfers (death of a partner

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

[184] § 1015(b).

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

[186] § 743(a).

or sale or exchange) often create discrepancies between inside and outside basis,[187] which in turn can create distortions in the amount of income recognized and the timing of the income. For example, if a partner dies (or a partner sells his or her partnership interest), the transferee partner (i.e., the estate) will have a basis in the partnership interest equal to fair market value (or the cost of the sale). If that basis is greater than the inside basis of the assets, when the partnership sells those assets, additional gain will be allocated to the transferee partner. The inside basis adjustment under section 743(b) attempts to adjust for these types of discrepancies, and the adjustments can increase or decrease the inside basis of partnership property.

2. A section 754 election is generally made by the partnership in a written statement filed with the partnership return for the taxable year during which the transfer in question (sale, exchange, death or distribution) occurs.[188] Once the election is made, it applies to the year for which it is filed as well as all subsequent taxable years until and unless it is formally revoked.[189] An election may be revoked if there exists: (i) a change in the nature of the partnership business; (ii) a substantial increase in or a change in the character of the partnership's assets; and (iii) an increase in the frequency of partner retirements or shifts in partnership interests (resulting in increased administrative costs attributable to the section 754 election).[190]

3. Many partnerships will forego the section 754 election because, as discussed herein, the section 743(b) adjustments require the partnership to track these basis adjustments for each transferee, which can be time consuming and onerous. They often rationalize this decision because the failure to make section 743(b) is really just an issue of timing, which can be solved by simply liquidating the transferred partnership interest. However, that is not always the case. By way of illustration, consider the situation of *Estate of Dupree v. United States*.[191] On the death of his wife, Mr. Dupree inherited an interest in a partnership, which owned a motel. The basis of the partnership interest was "stepped-up" to fair market value under section 1014, but because the partnership did not make a timely election under section 754, the motel did not get a corresponding basis increase under section 743(b). The partnership eventually sold the motel and Mr. Dupree was taxed on the full amount of the gain. His outside basis in the partnership was increased by the amount of the gain, which resulted in the interest having outside basis far in excess of its fair market value. A liquidation of his partnership interest should have resulted in a loss that would fully offset the gain on the sale, but in this instance, it did not. The buyer of the motel purchased the motel, in part, with promissory notes. When Mr. Dupree's partnership interest was liquidated, the promissory notes were distributed in-kind. Section 731(a)(2) provides that no loss is allowable on a liquidating distribution made with property in-kind.[192] Under section 732(b), the promissory notes were assigned a basis equal to Mr. Dupree's outside basis in his partnership interest (which was in excess of the remaining payments, unpaid principal, on the notes). If Mr. Dupree had lived to receive all of the payments on the promissory notes, he would have received a corresponding loss, but Mr. Dupree died shortly after the liquidation and the basis of the promissory notes were "stepped-down" under section 1014. Thus, the loss was never realized. If the partnership had a section 754 election in place on the first death, section 743(b) would have

[187] This is not always the case because "sale or exchange" includes a non-taxable transfer under sections 351 or 721, which generally provide for carryover basis. *See* Treas. Reg. § 1.755-1(b)(5)(i) addressing the allocation of the section 743(b) basis adjustment in "substituted basis transaction."

[188] Treas. Reg. § 1.754-1(b)(1). Under certain circumstances, there is a 12-month extension past the original deadline. Treas. Reg. § 301.9100-2.

[189] § 754 and Treas. Reg. § 1.754-1(a).

[190] Treas. Reg. § 1.754-1(c)(1).

[191] *Estate of Dupree v. United States*, 391 F.2d 753 (5th Cir. 1968).

[192] Only distributions of money and the basis to the distributee of any unrealized receivables and inventory (as defined in section 751) can create a loss upon liquidation. § 731(a)(2)(A) and (B).

increased the basis of the motel, thereby reducing the gain on the sale, and the basis of the notes received upon liquidation of the partnership interest would not have exceeded their face amount.[193]

4. If a partnership interest is held as community property, the death of either spouse may affect the basis of the entire interest. The deceased spouse's community property share of the interest is accorded a basis equal to its date-of-death (or alternate valuation date) value under section 1014(a) upon its transfer to his successor. The same basis consequences follow with respect to the surviving spouse's share of the interest (even though no actual transfer of this part of the interest took place) under section 1014(b)(6), which generally provides that the surviving spouse's community property share of the interest "shall be considered to have been acquired from or to have passed from the decedent" for purposes of section 1014(a). The IRS has ruled that section 743(b) applies to the entire partnership interest held as community property, regardless of which spouse dies first.[194] As long as the value of the partnership interest is greater than the decedent's share of the partnership's inside basis, this can be a significant benefit to taxpayers. However, what if the fair market value (including any applicable valuation discounts) is less than the decedent's share of the partnership's inside basis? It seems it can result in a decrease in inside basis to the detriment of the surviving spouse.

B. Basis Adjustments under Section 743(b) Are Notional

1. Essentially, the inside basis adjustment under section 743(b) is the difference between the outside basis that the transferee partner receives against the transferee's share of inside basis. Generally, after the section 743(b) adjustments, the transferee's basis in partnership assets should be same as it would have been had the transferee acquired a direct interest in the partnership assets. However, as discussed later in these material, the inside basis adjustments are controlled by section 755, which comes close, but does not exactly get the same result.

2. As noted above, when a partnership interest is included in the estate of a decedent, the adjustment to basis under section 1014 is reduced by the value attributable to items of IRD.[195] The Treasury Regulations provide, "Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c)…, the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under section 691. See Section 1.742-1. Accordingly, if a partnership interest is transferred as a result of the death of a partner, and the partnership holds assets representing income in respect of a decedent, no part of the basis adjustment under section 743(b) is allocated to these assets."[196]

3. Adjustments under section 743(b) result in either:

a. An increase in the transferee's share of partnership inside basis "by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property;"[197] or

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[193] *See also Estate of Ernest D. Skaggs*, 75 T.C. 191 (1980) , *aff'd per curiam*, 672 F.2d 756 (9th Cir. 1982) (cert. denied), in which the failure of a husband-wife partnership to make the election prevented a basis step-up for all of the partnership's assets upon the death of the husband under the rules applicable to community property.

[194] Rev. Rul. 79-124, 1979-1 C.B. 224.

[195] Treas. Reg. § 1.742-1.

[196] Treas. Reg. § 1.755-1(b)(4).

[197] § 743(b)(1).

b. A decrease in the transferee's share of partnership inside basis "by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership."[198]

4. A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, *plus* the partner's share of partnership liabilities.[199]

5. The partner's previously taxed capital is:[200]

a. The amount of cash the partner would receive upon a liquidation of the partnership following a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets;[201] *increased by*

b. The amount of tax loss that would be allocated to the partner in the hypothetical transaction; and *decreased by*

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

Example: A and B are equal partners in the AB Partnership. At the time of A's death, AB Partnership has a section 754 election in place, and the balance sheet of the partnership is as follows:

AB Partnership Balance Sheet					
Assets			**Liabilities**		
	Tax Basis	Book Value			Book Value
Asset A	$30x	$50x	Debt		$10x
Asset B	$10x	$50x	**Capital Accounts**		
				Outside Basis[202]	Capital Account
			Partner A	$25x	$45x
			Partner B	$25x	$45x
Total	**$40x**	**$100x**	**Total**	**$50x**	**$100x**

After A's death, the basis of A's interest in the partnership is adjusted under section 1014 to $50x (net equity value of $45x plus $5x in partnership liabilities, one-half share of the partnership liabilities).[203] The estate's interest in previously taxed capital is $15x ($45x of cash it would receive upon the hypothetical sale of assets, less $30x of gain allocated to the estate in the hypothetical transaction). The estate's proportionate share of the basis of

[198] § 743(b)(2).

[199] Treas. Reg. § 1.743-1(d)(1).

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

[201] Treas. Reg. § 1.743-1(d)(2).

[202] Includes each partner's share of the $10x of partnership liabilities.

[203] Treas. Reg. § 1.742-1.

the partnership property is thus $20x ($15x of previously taxed capital plus $5x share of partnership liabilities). As a result, the estate's section 743(b) adjustment is $30x ($50x outside basis less $20x of share of basis in the partnership property). As a result, the balance sheet of the partnership will be adjusted, effectively (although 743(b) basis adjustments are not actually made to the common basis of the partnership), as follows:

AB Partnership Balance Sheet					
Assets			**Liabilities**		
	Tax Basis	Book Value			Book Value
Asset A	$40x (+$10x)	$50x	Debt		$10x
Asset B	$30x (+$20x)	$50x	**Capital Accounts**		
				Outside Basis[204]	Capital Account
			A's Estate	$50x (+$25x)	$45x
			Partner B	$25x	$45x
Total	**$70x (+$30x)**	**$100x**	**Total**	**$75x (+$25x)**	**$100x**

6. Inside basis adjustments under section 743(b) do not change or affect capital accounts,[205] and because the adjustments only apply to the transferee, they are not made to the common basis of the partnership.[206] As a result, separate records must be maintained that reflect both the common basis and each transferee's section 743(b) basis adjustment for each partnership asset. Separate accounting is necessary for a number of purposes, including computation of depreciation and determination of adjustments in connection with subsequent transfers or distributions. The partnership will compute its taxable income, gain, loss, and deduction without regard to the inside basis adjustments under section 743(b), and then allocate these amounts among all the partners under the principles of section 704(b) of the Code. At this point, the inside basis adjustments then come into consideration. The partnership will adjust the transferee partner's distributive share of income, gain, loss, and deduction to reflect the adjustments. For example, if the partnership sells an asset that has a basis adjustment, the amount of the adjustment will reduce or increase the transferee's distributive share of the gain or loss from the sale of the asset.[207] Also, If a positive adjustment is made to depreciable (or amortizable) property, then the adjustment will increase the transferee's share of depreciation (or amortization) from that property. In effect, the transferee is treated as if he or she purchased new property for a price equal to the adjustment.[208]

[204] The reason net amount of basis adjustment to outside basis is different from the net amount of inside basis adjustment to the partnership assets is because outside basis includes each partner's share of partnership liabilities under section 752.

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

[206] Treas. Reg. § 1.743-1(j)(1). There is a limited exception in the case of certain distributions to a transferee partner. *See* Treas. Reg. § 1.734-2(b)(1).

[207] Treas. Reg. § 1.743-1(j)(3).

[208] Treas. Reg. § 1.743-1(j)(4).

7. The Treasury Regulations require the partnership to attach a statement to its tax return for the year of the transfer, setting forth the name and taxpayer identification number of the transferee, as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated.[209]

C. Focal Point: Section 704(c) and "Reverse" Section 704(c) Property

1. Because the inside basis adjustment is, in part, based upon the amount of gain or loss that would be allocated to the transferee of a partnership interest, a threshold partnership tax concept that must be addressed is how subchapter K of the Code deals with "section 704(c) property." Section 704(c) property is created when a partner contributes property under section 721 (tax free exchange of property for an interest in a partnership) and the fair market value of the property differs from its adjusted basis. When this occurs, the partner's capital account is credited based on the fair market value of the property,[210] but because it is a nontaxable exchange, the contributing partner's outside basis and the partnership inside basis are each equal to the adjusted basis of the property.[211] Why is this an issue?

2. The Treasury Regulations under section 704(b) point out that when appreciated (or depreciated, meaning with an unrealized loss) property is contributed to a partnership, the book value (fair market value at the time of contribution) reflected in the capital account of the contributing partner will be different from the adjusted tax basis of the property as reflected on the partnership's balance sheet. In such case, depreciation, depletion, amortization, and gain or loss with respect to such property "as computed for book purposes" will be "greater or less" than they would be "as computed for tax purposes."[212] This is often referred to as a "book/tax disparity."[213] Assuming that the partnership elects to follow capital account rules described in the Treasury Regulations[214] (which will almost always be the case[215]), then there is a "tax follows book" principle.

3. Pursuant to section 704(c)(1)(A), items of income, gain, loss, and deduction determined for tax purposes with respect to property contributed must be shared among partners in a manner that takes into account the variation between the partnership's adjusted tax basis in the property and the fair market value of the property at the time of contribution. Said another way, section 704(c)(1)(A) seeks to ensure that the historical tax characteristics at contribution associated with such difference will ultimately be allocated to the contributing partner. Thus, for example, when the contributed property is sold by the partnership, any inherent gain or loss (as calculated at the time of contribution) will be allocated to the contributing partner.[216] In that manner, section 704(c) ensures that the inherent gain or loss is not allocated

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[209] Treas. Reg. § 1.743-1(k)(1)(i). If the partnership holds oil and gas property that is depleted at the partner level under section 613A(c)(7)(D), the transferee must attach a statement to its return with the computation and allocation information. Treas. Reg. § 1.743-1(k)(1)(ii).

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

[211] §§ 722 and 723.

[212] Treas. Reg. § 1.704-1(b)(4)(i).

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

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

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

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

to the non-contributing partners. As the Treasury Regulations provide, "The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution."[217]

4. Because the fair market value of the contributed property is reflected in the contributing partner's capital account, if the partnership subsequently sells the property at the same value (e.g., at a gain), then the gain must be allocated to the contributing partner, but the partner's capital account must remain unaffected by the realization of that gain. Capital accounts already reflect the unrealized appreciation. Because of this, the Treasury Regulations provide, "In these cases the capital accounts of the partners are required to be adjusted solely for allocations of the book items to such partners…, and the partners' shares of the corresponding tax items are not independently reflected by further adjustments to the partners' capital accounts."[218]

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

5. A related issue occurs when a partner is admitted into (or withdraws from) an existing partnership and the partnership has property with a value (book value) that is greater (or less than) the partnership's inside basis (tax value) in the property. This is illustrated in the following example:

> **Example:** A and B create a newly-formed AB Partnership as equal partners. Both A and B contribute cash of $100x each to AB Partnership. In year 1, AB Partnership purchases Asset AB for $200x. Both A and B's tax (outside basis) and book (capital) accounts are $100x each. In year 2, AB Asset appreciates to $300x in value, and AB Partnership admits C, who contributes Asset C that has an adjusted basis of $50x and a fair market value of $150x, as an equal one-third partner. At the time of C's contribution, A and B's book capital accounts are $100x each, but C's book capital account is $150x. Assuming that the partnership follows the "safe harbor" allocation method for substantial economic effect (i.e., liquidation distributions will be made according to the partners' positive book capital account balances), if the AB partnership liquidated at this point, A and B's capital account would not accurately reflect the unrealized (pre-entry) appreciation in Asset AB that accrued prior to C's admission to the partnership.

6. To solve the foregoing issue, the Treasury Regulations allows a partnership to revalue ("book-up") its assets (including intangible assets like goodwill) at their current fair market value and

[217] Treas. Reg. § 1.704-3(a)(1).

[218] Treas. Reg. § 1.704-1(b)(4)(i).

correspondingly adjust all of the partner's book capital accounts. The book-up adjustments to capital account are determined as if the partnership had sold all of its assets for their fair market value, and the resulting gain and loss with respect to each asset is allocated to the pre-existing partners under the terms of the partnership agreement.[219] The result is the pre-existing partners' book capital accounts will reflect the "booked-up" fair market value of the assets on the partnership at the time of the admission of the new partner. So, in the foregoing example, A and B's book capital accounts would be adjusted upward from $100x to $150x each, and the partnership's book value for AB Asset on the balance sheet would be adjusted upward from $200x to $300x.

7. Under the foregoing example, after the book-up of partnership assets and the admission of C to the partnership, each of the partners has a book capital account of $150x. C has a tax (outside basis) account of $50x. The unrealized $100x inherent in Asset C will ultimately be allocated to C under section 704(c)(1)(A) because, as discussed above, it applies to appreciation that occurred *before* C became a partner. In contrast, A and B each has a tax account of $100x, and the unrealized appreciation reflected in the "book-tax disparity" is due to unrealized appreciation that occurred *after* A and B became partners. It is because of this distinction that the allocations with respect to the AB Asset are referred to as "reverse" section 704(c) allocations.[220] Although the resulting allocations to resolve the book-tax disparity created upon contribution of property to a partnership or the admission of a new partner are all sourced under section 704(c), the Treasury Regulation provide, "Partnerships are not required to use the same allocation method for reverse section 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to section 704(c)."[221]

8. Book-up revaluations of partnership property are allowable, under the Treasury Regulations, as long as five criteria are met:

a. The adjustments must be based on the fair market value of partnership property on the date of the adjustment;[222]

b. The adjustments to book capital accounts must reflect the manner in which unrealized income, gain, loss, or deduction inherent in partnership property will be allocated among the partners if the property had been sold for fair market value.[223]

c. The partnership agreement requires that capital accounts will be maintained according to rules set out in the Treasury Regulations with respect to allocations of depreciation, depletion, amortization, and gain or loss;[224]

d. The partnership agreement requires that the partners' distributive share of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property under section 704(c);[225] and

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[219] Treas. Reg. § 1.704-1(b)(2)(iv)(*f*).

[220] *See* Treas. Reg. § 1.704-3(a)(6)(i).

[221] *Id.*

[222] Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*1*).

[223] Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*2*).

[224] Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*3*).

[225] Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*4*).

e. The revaluation adjustments must be made principally for a substantial non-tax business purpose.[226]

9. Book-up revaluations are appropriate for a myriad of partnership transactions, not just contributions of property and admissions of partners, as discussed up this point. The list of these types of transactions contained in the Treasury Regulations include the following:[227]

a. Contribution of money or property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership;

b. Liquidation of the partnership;

c. Distribution of money or property (other than a de minimis amount) by the partnership to a retiring partner or continuing partner as consideration for an interest in the partnership;

d. Grant of a partnership interest as consideration for the provision of services to or for the benefit of the partnership;

e. Partnership's issuance of a non-compensatory option for a partnership interest (other than for a de minimis interest); and

f. If substantially all of the partnership's property (excluding money) consists of stocks, securities, commodities, options, warrants, future or similar instruments that are readily tradable on an established market, those transactions as set forth under generally accounting practices.

10. Generally, property may not be aggregated for purposes of making allocations under section 704(c). The Treasury Regulations generally provide that section 704(c) allocations apply on a property-by-property basis.[228] That being said, the following types of property may be aggregated, as long as they are contributed by one partner in a single tax year: (i) depreciable property, other than real property, included in the same general asset account of the contributing partner and the partnership under section 168; (ii) property, other than real property, with a zero adjusted basis; and (iii) inventory, other than "qualified financial assets,"[229] that does not use a specific identification method of accounting.[230]

> **Example**: A and B create a newly-formed AB Partnership as equal partners. A contributes Asset A with an adjusted basis of $40x and fair market value of $100x, and B contributes cash of $100x to AB Partnership. Asset A appreciates in value to $120x. A dies. At the time of A's death, AB Partnership has a section 754 election in place, and the balance sheet of the partnership is as follows:

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

[227] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*)(*i*) through (*v*).

[228] Treas. Reg. § 1.704-3(a)(2).

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

[230] Treas. Reg. § 1.704-3(e)(2).

AB Partnership Balance Sheet					
Assets			**Liabilities**		
	Tax Basis	Book Value			Book Value
Asset A	$40x	$120x	Debt		$0x
Cash	$100x	$100x	**Capital Accounts**		
				Outside Basis	Capital Account
			Partner A	$40x	$110x
			Partner B	$100x	$110x
Total	**$140x**	**$220x**	**Total**	**$140x**	**$220x**

After A's death, the basis of A's interest in the partnership is adjusted under section 1014 to $110x (equal to A's capital account balance at death).[231] The estate's interest in previously taxed capital is $40x ($110x of cash it would receive upon the hypothetical sale of assets, less $70x of gain ($60x of section 704(c) gain and $10x of section 704(b) gain, representing A's 50% share of post-contribution gain in Asset A) allocated to the estate in the hypothetical transaction). The estate's proportionate of the basis of the partnership property is thus $40x ($40x of previously taxed capital plus $0x partnership liabilities). As a result, the estate's section 743(b) adjustment is $70x ($110x outside basis less $40x of share of basis in the partnership property). As a result, the balance sheet of the partnership will be adjusted, effectively (although 743(b) basis adjustments are not actually made to the common basis of the partnership), as follows:

AB Partnership Balance Sheet					
Assets			**Liabilities**		
	Tax Basis	Book Value			Book Value
Asset A	$110x (+$70x)	$120x	Debt		$0x
Cash	$100x	$100x	**Capital Accounts**		
				Outside Basis	Capital Account
			A's Estate	$110x (+$70x)	$110x
			Partner B	$100x	$110x
Total	**$210x (+$70x)**	**$220x**	**Total**	**$210x (+$70x)**	**$220x**

11. As noted above, the Treasury Regulations provide that a partnership must allocate items of income, gain, loss, or deduction with respect to contributed property so as to prevent the shifting of tax consequences among partners with respect to built-in gain or built-in loss. The allocations must be made using a reasonable method that is consistent with the purpose of section 704(c).[232] Property contributed with built-in gain (or loss) is referred to as "section 704(c) property" (contributed property with a section 704(b) book value [capital account] that is different than the contributing partner's adjusted tax basis in the

[231] Treas. Reg. § 1.742-1. AB Partnership has no liabilities.

[232] *See* Treas. Reg. § 1.704-3(a)(1).

property).[233] In the context of contributions of property, the Treasury Regulations describe three methods that are deemed reasonable for taking book-tax differences into account: (1) the traditional method; (2) the traditional method with curative allocations; and (3) the remedial allocation method. Other reasonable methods are permissible.[234] Although the Treasury Regulations discuss the application of section 704(c) allocations with respect to contributions of property, the same principles apply to reverse section 704(c) allocations when there is a partnership revaluation or book-up, as mentioned above.[235] A full discussion of these methods is beyond the scope of these materials but some mention is warranted.

a. The traditional method is described in section 1.704-3(b) of the Treasury Regulations. Under this method, if the partnership sells all or a portion of section 704(c) property and recognizes gain or loss, then any built-in gain (or loss) that existed at the time of the contribution must be allocated to the contributing partner.[236] When only a portion of the property is sold, a proportionate part of the built-in gain (or loss) at the time of the contribution is allocated to the contributing partner.[237] The traditional method is subject to the "ceiling rule," which can limit the amount of the section 704(c) allocations. The Treasury Regulations provide, "the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule)."[238]

b. The Treasury Regulations allow partnerships to elect to cure the deficiencies to the noncontributing partner that are created by the ceiling rule by making reasonable "curative" allocations with the traditional method.[239] As described in section 1.704-3(c) of the Treasury Regulations, "To correct distortions created by the ceiling rule, a partnership using the traditional method … may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners. A curative allocation is an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item."[240] A partnership may limit its curative allocations to a particular tax item even if allocation of those available items does not fully offset the effect of the ceiling rule.[241] A partnership must be consistent with its application of curative allocations with respect to each item of property from year to year.[242] A curative allocation will be reasonable: (i) only up to the amount necessary to offset the effect of the ceiling rule (i.e., only up to the amount necessary to make the tax allocation to the noncontributing partner equal to its corresponding book allocation) for the current tax year (or, in the case of a curative allocation upon disposition of the property, for prior tax years);[243] and (ii) only if it is made using a tax item that must be expected to have substantially the same

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[233] Treas. Reg. § 1.704-3(a)(3).

[234] Treas. Reg. § 1.704-3(a)(1).

[235] Treas. Reg. § 1.704-1(b)(3)(iv)(*f*).

[236] Treas. Reg. § 1.704-3(b)(1).

[237] *Id.*

[238] *Id.*

[239] For an excellent article on using section 704(c) allocation in the family partnership context, see Thomas N. Lawson, *Using Curative and Remedial Allocations to Enhance the Tax Benefits of FLPs*, 9 Est. Plan. No. 8, pg. 12 (Aug. 2009).

[240] Treas. Reg. § 1.704-3(c)(1).

[241] *Id.*

[242] Treas. Reg. § 1.704-3(c)(2).

[243] Treas. Reg. § 1.704-3(c)(3)(i).

effect on each partner's tax liability as the tax item affected by the ceiling rule.[244] The period of time over which curative allocations are made must be taken into account in determining whether the allocations are reasonable.[245] However, a partnership may make a curative tax allocation that offsets the effect of the ceiling rule for a prior tax year, if they are made over a reasonable period of time.[246]

c. Section 1.704-3(d) provides a third allocation method, the remedial allocation method, which involves the partnership creating notional (hypothetical) tax items that are not dependent upon actual tax items recognized by the partnership.[247] In this manner, the partnership can create offsetting tax items that do not actually exist to eliminate book-tax disparities created by the ceiling rule. The Treasury Regulations provide that in the absence of other published guidance, the remedial allocation method is the only reasonable section 704(c) method permitting the creation of notional tax items.[248] Under the remedial allocation method, the partnership allocates tax items on 704(c) property under the traditional method, and then, the Treasury Regulations instruct:[249]

> If the ceiling rule…causes the book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner.

In other words, remedial allocations to noncontributing partners and offsetting remedial allocations to the contributing partner net to zero at the partnership level. Thus, remedial allocations, in the aggregate, do not affect the partnership's taxable income, as determined under section 703.[250] In addition, unlike curative allocations, remedial allocations must fully offset the disparity created by the ceiling rule.[251] In contrast, at the partner level, the remedial allocations are actual tax items that must be recognized.[252] As such, remedial allocations will affect the partner's tax liability and will be reflected in the outside basis of the partner's interest in the partnership.

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[244] Treas. Reg. § 1.704-3(c)(3)(iii).

[245] Treas. Reg. § 1.704-3(c)(3)(ii)

[246] *Id.*

[247] *See* Treas. Reg. § 1.704-3(d)(4) and the preamble to T.D. 8585, 59 Fed. Reg. 66,725 (Dec. 29, 1004).

[248] Treas. Reg. § 1.704-3(d)(5)(i).

[249] Treas. Reg. § 1.704-3(d)(1).

[250] Treas. Reg. § 1.704-3(d)(4)(i).

[251] Treas. Reg. § 1.704-3(d).

[252] Treas. Reg. § 1.704-3(d)(4)(ii).

D. Allocating Section 743(b) Inside Basis Adjustments under Section 755

1. The Treasury Regulations provide that the inside basis adjustment is divided between two classes of partnership assets: (i) "ordinary income property," and (ii) "capital gain property."[253] For these purposes, "capital gain property" includes capital assets and section 1231(b) property.[254] All other property (including unrealized receivables and recapture items under section 751(c) of the Code) is considered "ordinary income property."[255] Next, the portion of the adjustment allocated to each class of assets is then further divided among the assets in each class. The mechanism for making the allocation in this second step is different depending on whether the inside basis adjustment is under section 734(b) (i.e., distributions of property) or section 743(b) (i.e., sale or exchange of a partnership interest or death of a partner) of the Code.

2. As mentioned above, inside basis adjustments under section 743(b) of the Code only apply to the transferee. The Treasury Regulations treat the total amount of these adjustments as a net amount, which means that positive adjustments can be made with respect to some assets (or one class of assets), and negative adjustments can be made with respect to other assets (or class).[256] For purposes of calculating the amount to be allocated to each class and to each asset within a class, the Treasury Regulations employ a hypothetical transaction pursuant to which you must calculate the transferee's allocable share of gain or loss from each asset if immediately after the transfer, the partnership made a cash sale of all of the partnership assets for fair market value.[257] Keep in mind, even a straightforward "pro rata" partnership with each partner having a percentage interest in the partnership and no special allocations of tax items, the amount of gain or loss may be disproportionate due to section 704(c) or "reverse" 704(c) allocations.[258]

3. The portion of the basis adjustment allocated to ordinary income property is equal to the total income, gain, and loss that would be allocated to the transferee with respect to the sale of ordinary income property in the hypothetical transaction.[259] The basis adjustment to capital gain property is equal to the total section 743(b) basis adjustment reduced by the amount allocated to ordinary income property.[260] If the basis adjustment to capital gain property turns out to be a decrease under this formula, it may not exceed "the partnership's basis (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under § 1.704-3(d) from the hypothetical transaction) in capital gain

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[253] Treas. Reg. § 1.755-1(a).

[254] Generally is "property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year," and that is not inventory, intellectual property, or property held for sale to customers. § 1231(b)(1).

[255] *Id.*

[256] Treas. Reg. § 1.755-1(b)(1). See Treas. Reg. § 1.755-1(2)(ii), Ex. 1 (results in a decrease in basis to ordinary income property and an increase in basis to capital gain property) and Ex. 2 (a section 743(b) adjustment equal to zero results in a decrease in basis to ordinary income property and an increase in basis to capital gain property of an equal amount).

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

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

[259] Treas. Reg. § 1.755-1(b)(2)(i).

[260] *Id.*

property."[261] The balance of any decrease is applied "to reduce the basis of ordinary income property."[262] This approach effectively allocates any overpayment or underpayment to the basis of capital gain property, so that a transferee who overpays (or a valuation premium) for a partnership interest generally will find the basis of his share of partnership capital gain property inflated by the entire amount of the overpayment, whereas a transferee who underpays (or a valuation discount) generally will have the entire underpayment (or valuation discount) applied against the basis of partnership capital gain property.

4. If the purchase price of a partnership interest or the fair market value of the asset upon the death of a partner is equal to the selling partner's or deceased partner's share of the partnership assets (as reflected in the capital account and such partner's share of the inside basis of the partnership assets), then the general result will be that the inside basis adjustments under section 743(b) will exactly offset the buyer's gain or loss inherent in each asset. However, that is not always the case. If the buyer pays a premium over asset value or the partnership interest carries a valuation premium, then under the residual method utilized under section 1060 of the Code, the excess will be allocated to goodwill or other section 197 intangibles. If the buyer purchases at a discount below fair market value (or more likely in the estate planning context, the deceased partner's partnership interest is valued at a discount for purposes of section 1014 of the Code), the Treasury Regulations first allocate the adjustment to ordinary income property to the extent possible, [263] and then provide a mechanism to allocate the shortfall (in the capital gain class) based upon two factors: (i) unrealized appreciation (or depreciation) in each asset, and (ii) each asset's relative fair market value.[264]

5. More specifically, in allocating this shortfall, the amount of basis adjustment to each item of property within the class of capital gain property is the amount of income, gain, or loss that would be allocated to the transferee (attributable to the acquired partnership interest) from the hypothetical sale of the item;[265] minus the product of:[266]

a. "The total amount of gain or loss … that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of capital gain property, minus the amount of the positive basis adjustment to all items of capital gain property or plus the amount of the negative basis adjustment to capital gain property;"[267] multiplied by

b. "A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property."[268]

> **Example:** AB Partnership has two equal partners, A and B. AB Partnership has a section 754 election in place. A dies, and A's partnership interest has its outside basis "stepped-up" under section 1014. It is determined that A's estate is entitled to a $35x inside basis increase under section 743(b). In the allocation of the inside basis adjustment, it is

[261] Treas. Reg. § 1.755-1(b)(2)(i)(B).

[262] *Id.*

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

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

[265] § 1.755-1(b)(3)(ii)(A).

[266] § 1.755-1(b)(3)(ii)(B).

[267] § 1.755-1(b)(3)(ii)(B)(1).

[268] § 1.755-1(b)(3)(ii)(B)(2).

determined that the basis of ordinary property is reduced by -$12.50x, which in turn, produces a positive basis adjustment of $36.25x to the following capital gain assets: (i) Asset A has an adjusted basis of $25x and a fair market value of $75x, and the first $25x of the unrealized gain is section 704(c) gain; and (ii) Asset B has an adjusted basis of $100x and a fair market value of $117.5x.

In the hypothetical transaction under section 755, A's estate would be allocated $37.5x of gain with respect to Asset A and $8.75x with respect to Asset B. The total amount of gain is $46.25x, which is $10x in excess of the total section 743(b) adjustment to capital gain property of $36.25x. The $10x is the reduction that must be allocated pursuant to Treasury Regulation section 1.755-1(b)(3)(ii)(B) quoted above.

Asset A's basis is initially increased by the total amount of gain that would be allocated to A's estate in the hypothetical transaction. Asset A's basis is initially increased to $37.5x. Then it is reduced based upon the relative fair market values of Asset A and Asset B. The value of Asset A is $75x and the total value of both assets is $192.5x ($75x plus $117.5x). Under the formula above, the portion of the reduction that will be applied to Asset A is equal to 38.96% ($75x divided by $192.5x). As a result, Asset A's basis is reduced from $37.5x to $33.604x (reduced by $3.896x – [38.96% of $10,000]).

Asset B's basis is initially increased by the total amount of gain that would be allocated to A's estate in the hypothetical transaction. Asset A's basis is initially increased to $8.75x. Then it is reduced based upon the relative fair market values of Asset A and Asset B. The value of Asset B is $117.5x and the total value of both assets is $192.5x. Under the formula above, the portion of the reduction that will be applied to Asset A is equal to 61.04% ($117.5x divided by $192.5x). As a result, Asset B's basis is reduced from $8.75x to $2.646x (reduced by $6.104x – [61.104% of $10,000]).

E. Distributions of Section 743(b) Basis-Adjusted Property

1. A distribution of partnership property with respect to which a transferee-partner has a special basis adjustment under section 743(b) may necessitate a reallocation of the special basis adjustment. The principles governing reallocations in connection with distributions are set forth in section 1.743-1(g) of the Treasury Regulations. In applying these reallocations, the Treasury Regulations under section 755 divide the partnership assets into ordinary income and capital gain property.[269] The Treasury Regulations provide the reallocation "must be allocated to the remaining property of a character similar to that of the distributed property with respect to which the adjustment arose."[270]

2. If a distribution is solely to a partner entitled to a special basis adjustment with respect to the distributed property, the distributee is entitled to add (or subtract) his special basis adjustment to (or from) the partnership's adjusted basis in the property for purposes of determining his post-distribution basis in the property under section 732.[271]

3. If property is distributed to partners entitled to a special basis adjustment and to other partners in the same transaction, a distributee who is not entitled to a special basis adjustment does not take

[269] Treas. Reg. §§ 1.755-1(a), 1.755-1(c), and 1.743-1(g).

[270] Treas. Reg. § 1.755-1(c)(1).

[271] Treas. Reg. § 1.743-1(g)(1)(i)

another's adjustment into account in determining the basis of property distributed to such distributee. A distributee entitled to a special basis adjustment with respect to both property distributed to him and property distributed to other partners takes into account his entire basis adjustment with respect to the property he or she receives.[272] A distributee's special basis adjustment with respect to the property distributed to other partners is reallocated among the "remaining items" of partnership property.[273]

4. If the distribution is in complete liquidation of the distributee's interest, he is required to reallocate any special basis adjustments in property retained by the partnership to any property of the same class distributed to the distributee.[274] This rule for liquidating distributions does not affect the distributee's aggregate basis in property distributed in liquidation. Under section 732(b), that amount is equal to the distributee's basis in his or her partnership interest (less any cash distributed).

F. Transfers of Partnership Interests after Section 743(b) Adjustments

1. The Treasury Regulations provide if "there has been more than one transfer of a partnership interest, a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment."[275]

2. In the case of a gift of a partnership interest (presumably including a subsequent transfer from the estate of a decedent to a beneficiary), "the donor is treated as transferring, and the donee as receiving, that portion of the basis adjustment attributable to the gifted partnership interest."[276]

3. The Treasury Regulations provide the following example:[277]

> (i) A, B, and C form partnership PRS. A and B each contribute $1,000 cash, and C contributes land with a basis and fair market value of $1,000. When the land has appreciated in value to $1,300, A sells its interest to T1 for $1,100 (one-third of $3,300, the fair market value of the partnership property). An election under section 754 is in effect; therefore, T1 has a basis adjustment under section 743(b) of $100.
>
> (ii) After the land has further appreciated in value to $1,600, T1 sells its interest to T2 for $1,200 (one-third of $3,600, the fair market value of the partnership property). T2 has a basis adjustment under section 743(b) of $200. This amount is determined without regard to any basis adjustment under section 743(b) that T1 may have had in the partnership assets.
>
> (iii) During the following year, T2 makes a gift to T3 of fifty percent of T2's interest in PRS. At the time of the transfer, T2 has a $200 basis adjustment under section 743(b). T2 is treated as transferring $100 of the basis adjustment to T3 with the gift of the partnership interest.

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[272] *Id.*

[273] Treas. Reg. § 1.743-1(g)(2)(ii).

[274] Treas. Reg. § 1.743-1(g)(3).

[275] Treas. Reg. § 1.743-1(f) and Prop. Treas. Reg. § 1.743-1(f)(1).

[276] *Id.*

[277] *Id.*

G. Mandatory Inside Basis Adjustment: Substantial Built-In Loss

1. As noted, if there is a transfer of a partnership interest due to a "sale or exchange or on the death of a partner," a partnership must make mandatory inside basis adjustments under section 743(b) if the partnership has a "substantial built-in loss" immediately after the transfer.

2. Since the enactment of TCJA, a partnership is deemed to have "substantial built-in loss" if:

(1) The partnership's total adjusted bases in partnership property exceeds the properties' total fair market value by more than $250,000 immediately after the transfer of the partnership interest;[278] or

(2) Effective for transfers of partnership interests after December 31, 2017, "the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their fair market value immediately after such transfer."[279]

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

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

> **Example**: AB Partnership has two equal partners, A and B. The partnership does not have any liabilities. The balance sheet of the partnership is as follows (all assets are capital assets):

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

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

[278] § 743(d)(1)(A).

[279] § 743(d)(1)(B).

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$500,000	$500,000	Partner A	$900,000	$750,000
Asset B	$400,000	$500,000	B's Estate	$750,000 (-$150,000)	$750,000
Asset C	$900,000	$500,000			
Total	**$1,800,000**	**$1,500,000**	**Total**	**$1,650,000 (-$150,000)**	**$1,500,000**

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

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$500,000	$500,000	Partner A	$900,000	$750,000
Asset B	$450,000 (+$50,000)	$500,000	B's Estate	$750,000 (-$150,000)	$750,000
Asset C	$700,000 (-$200,000)	$500,000			
Total	**$1,650,000 (-$150,000)**	**$1,500,000**	**Total**	**$1,650,000 (-$150,000)**	**$1,500,000**

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

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

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

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

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

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

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

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$600,000 (+S100,000)	$700,000	Partner A	$800,000	$800,000
Asset B	$300,000 (+$200,000)	$500,000	B's Estate	$800,000	$800,000
Asset C	$700,000 (-$300,000)	$400,000			
Total	**$1,600,000**	**$1,600,000**	**Total**	**$1,600,000**	**$1,600,000**

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

gain or loss in the partnership assets. Prior to death, B's share of unrealized gain in Assets A and B was $100,000 and $200,000 respectively, and B's share of unrealized loss in Asset C was $400,000. After death, even with no net change in outside basis under section 1014 and the mandatory basis adjustment, B's estate has no unrealized gain or loss in Assets A, B and C.

6. In 2014, the IRS published proposed Treasury Regulations on the application of section 704(c)(1)(C) (contributions of built-in loss property).[280] These same proposed regulations provide rules that would apply if a partnership has a substantial built-in loss immediately after a transfer. These proposed rules will be effective for transfers of partnerships occurring on or after the regulations are finalized.[281] They have not yet been finalized. In such case, the proposed rules provide that the partnership would be treated as having a section 754 election in effect for the year of the transfer but only with respect to that transfer.[282] Any subsequent transfer would need to be tested separately to determine whether a mandatory basis adjustment is required.

7. The proposed regulations also provide rules for determining the value of an upper-tier partnership's interest in a lower-tier partnership. The value of an upper-tier partnership's interest in a lower-tier partnership would be equal to the sum of: (1) the amount of cash that the upper-tier partnership would receive if the lower-tier partnership sold all of its assets for cash to an unrelated buyer at fair market value, satisfied all its (other than Treasury Regulation section 1.752-7 liabilities), paid an unrelated person to assume all of its section 1.752-7 liabilities in a fully taxable arm's-length transaction, and liquidated; and (2) the upper-tier partnership's share of the lower-tier partnership liabilities, as determined under section 752 of the Code.[283] The practical effect of the foregoing is to eliminate any potential valuation discounts that could be claimed for the interest in the lower-tier partnership. In addition, the proposed regulations provide if a partner transfers an interest in an upper-tier partnership that holds (directly or indirectly) an interest in a lower-tier partnership, and the upper-tier partnership has a substantial built-in loss after the transfer, each lower-tier partnership would be treated as if it made a section 754 election with respect to that transfer.[284]

8. The proposed regulations also contain an anti-abuse provision for built-in loss transactions. It provides, "if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of one or more of these paragraphs, the Commissioner may recast the transaction for Federal income tax purposes, as appropriate, to achieve tax results that are consistent with the purpose of these paragraphs."[285] It provides these two examples of potentially abusive situations:

a. "Property held by related partnerships may be aggregated if the properties were transferred to the related partnerships with a principal purpose of avoiding the application of the substantial built-in loss provisions in section 743 and the regulations;"[286] and

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

[281] Prop. Treas. Reg. § 1.743-1(p).

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

[283] Prop. Treas. Reg. § 1.743-1(a)(2)(ii).

[284] Prop. Treas. Reg. § 1.743-1(l)(1).

[285] Prop. Treas. Reg. § 1.743-1(m).

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

b. "A contribution of property to a partnership may be disregarded if the transfer of the property was made with a principal purpose of avoiding the application of the substantial built-in loss provisions in section 743 and the regulations thereunder."[287]

H. Mandatory "Step-Down" of Partnership Assets

1. Partnership Interest Is Included in the Gross Estate

a. In the last example above, the death of Partner B, resulted in a net mandatory basis adjustment of zero, but the appreciated assets (Asset A and Asset B) had their adjusted bases increased (to eliminate the estate's share of gain in those assets) and the loss property (Asset C) had its adjusted basis decreased by $300,000 (to eliminate the estate's share of the unrealized loss in Asset C). The net result is effectively as if B died directly owning a one-half interest in Assets A, B, and C. Partner B's interest in the appreciated property would get a "step-up" in basis, and Partner B's interest in the loss property would get a "step-down" in basis.

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

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

2. Partnership Interest Is Subject to a Valuation Discount

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

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

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

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

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

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$512,500 (+$12,500)	$700,000	Partner A	$800,000	$800,000
Asset B	$237,500 (+$137,500)	$500,000	B Estate	$600,000 (-$200,000)	$800,000
Asset C	$650,000 (-$350,000)	$400,000			
Total	**$1,400,000 (-$200,000)**	**$1,600,000**	**Total**	**$1,400,000 (-$200,000)**	**$1,600,000**

The total inside basis adjustment is the difference between the transferee's outside basis ($600,000) and the transferee's share of the basis of the partnership property, which is the sum of the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities. There are no liabilities in this example. The partner's previously taxed capital is $200,000, determined as follows: (i) $800,000 (the amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets); plus (ii) $300,000 (the amount of tax loss from Asset C that would be allocated to the partner on the hypothetical transaction); less (iii) the $300,000 (the amount of tax gain from Assets B and C that would be allocated to the partner on the hypothetical transaction). As a result, the total net inside basis adjustment under section 743(b) is -$200,000 ($600,000 outside basis minus partner's share of the partnership property of $800,000).

Unlike the previous example, which had a net zero basis adjustment, the basis adjustment in this instances is -$200,000. That negative adjustment is allocated to each asset in the following amounts:[288]

Asset A has an upward basis adjustment of $87,500 ($100,000 gain on hypothetical sale *minus* [$200,000 net inside basis adjustment *multiplied by* ($700,000 value of Asset A *divided by* $1,600,000 value of all assets)] = $12,500).

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

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

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

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

The transferee's share of basis in Asset B in $137,500 and a value of $250,000 (unrealized gain of $62,500).

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

b. As can be seen, when there isn't a full basis adjustment under section 1014 to capital account value due to valuation discounts, the assets in the partnership do not get a full inside basis adjustment that eliminates all of the transferee's unrealized gain or loss in the partnership property. In this instance, even Asset C, which was at a loss at the time of death, ends up with an unrealized gain. The results may seem idiosyncratic, but the Treasury Regulations prorate the shortfall based upon the value of the assets, not the unrealized gain or loss in the assets.[289]

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

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

b. If one of the trust assets is a partnership interest and the partnership has a "substantial built-in loss" as defined in section 743(d)(1), it's unclear whether the transfer will trigger a mandatory inside basis adjustment. The policy reason that it should not trigger the mandatory inside basis adjustment is the deemed transfer of the partnership interest to the trust does not result in any change in the outside basis of the partnership interest. For example, if a taxpayer makes a gift of a partnership interest to

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

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

his or her child, by way of example, and the partnership has a "substantial built-in loss," section 743(d)(1) does not apply. That is because it only applies "In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner…"[290] The assumption is that the phrase "upon the death of a partner" refers to an individual partner owning the interest at the time of his or her death, not to a deemed transfer caused by the conversion from grantor to non-grantor trust. However, this position is not without doubt.

c. In Revenue Ruling 79-84,[291] the IRS held that a deemed transfer of a partnership interest to a grantor trust caused by the death of the grantor requires an inside basis adjustment under section 743(b) because the partnership had a section 754 election in place. The ruling provides:[292]

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

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

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

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

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

> The partnership itself does not have a "substantial built-in loss" because the total inside basis of the partnership assets is equal to the fair market value of those assets. However, there is a "substantial built-in loss" at the partner level. At that time, B passes away and

[290] § 743(b)

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

[292] *Id.*

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

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

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

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

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$600,000 (+$100,000)	$700,000	Partner A	$800,000	$800,000
Asset B	$300,000 (+$200,000)	$500,000	Taxable Trust	$800,000	$800,000
Asset C	$700,000 (-$300,000)	$400,000			
Total	**$1,600,000**	**$1,600,000**	**Total**	**$1,600,000**	**$1,600,000**

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

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

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

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

III. DISTRIBUTIONS OF PROPERTY IN LIEU OF THE INSIDE BASIS ADJUSTMENT

A. Elective Section 732(d) Distributions

1. Even with no section 754 election, the estate or successor in interest can achieve the same benefits of an inside basis adjustment if the partnership makes a distribution of property (other than money) within two years of the date of death and if the successor partner makes an election under section 732(d).[293] The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis has tax significance.[294]

2. The basis adjustment is computed under section 743(b), which relates to the basis adjustments due to sales or transfer of partnership interest (during lifetime, or more notably for this discussion, at death). The inside basis adjustment is made artificially to all of the partnership property owned on the date of death (for purposes of determining the transferred inside basis to the distributee with respect to the property distributed). In other words, it is allocated to all of the partnership property whether actually distributed or not.[295] If any property for which the distributee/transferee would have had an inside basis adjustment is distributed to another partner, the adjustment for such distributed property is reallocated to remaining partnership property.[296]

3. The election under section 732(d) can be a significant planning opportunity especially when planners would like to avoid having a section 754 election in place. As mentioned above, once the section 754 election is made, it is irrevocable unless the IRS gives permission to revoke the election. Because the inside basis adjustments under section 743(b) only apply to the transferees of the partnership interests (not to the partnership as a whole), having a section 754 election in place requires having a different set of basis calculations for the transferees of the interest. The bookkeeping requirements become quite onerous as partnership interests are often distributed at death to multiple trusts or beneficiaries and become even more so as additional partners pass away.

4. If the distribution of property is made pursuant to provision in the partnership agreement that requires a mandatory in-kind liquidation of the deceased partner's interest based on the partner's positive capital account balance, then the estate would have a good argument to say that the value of the partner's interest for purposes of section 1014(a) should not entail valuation discounts. This would, in turn, increase the inside basis adjustment on the assets claimed with the section 732(d) election. Giving the manager of the LLC or general partner of the partnership the discretion to determine what assets to distribute in liquidation of the partnership interest could give considerable planning opportunities to pick and choose which assets to receive the inside basis adjustment based on the needs of the distributee partner. While the assets received would likely not receive full fair market value (because, as mentioned above, the inside basis adjustment is artificially allocated across all of the partnership assets whether distributed or not), some planning opportunities could exist by distributing assets to other partners prior to the liquidation because the nominal inside basis adjustment that would have been allocated to those assets would be adjusted to the remaining partnership property.

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[293] Treas. Reg. § 1.732-1(d)(1)(iii).

[294] Treas. Reg. § 1.732-1(d)(2).

[295] Treas. Reg. §§ 1.732-1(d)(1)(vi), 1.743-1(g)(1) and (5), Ex. (ii).

[296] Treas. Reg. §§ 1.743-1(g)(2) and (5), Ex. (iv).

Example: ABCD Partnership has four equal partners, A, B, C, and D. The partnership does not have any liabilities or items of IRD, and all of the assets in the partnership are capital assets. The balance sheet of the partnership is, as follows:

ABCD Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$400x	$400x	Partner A	$400x	$400x
Asset B	$100x	$400x	Partner B	$100x	$400x
Asset C	$100x	$400x	Partner C	$100x	$400x
Asset D	$100x	$400x	Partner D	$100x	$400x
Total	**$700x**	**$1,600x**	**Total**	**$700x**	**$1,600x**

D passes away. Assume the fair market value of D's interest is equal to D's capital account balance ($400x). As a result, the outside basis of the D's partnership interest gets a "step-up" to $400x. ABCD Partnership does not have a section 754 election in effect at the time of D's death. As a result, the balance sheet looks, as follows:

ABCD Partnership Balance Sheet (No Section 754 Election)					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$400x	$400x	Partner A	$400x	$400x
Asset B	$100x	$400x	Partner B	$100x	$400x
Asset C	$100x	$400x	Partner C	$100x	$400x
Asset D	$100x	$400x	D's Estate	$400x (+$300x)	$400x
Total	**$700x**	**$1,600x**	**Total**	**$1,000x (+$300x)**	**$1,600x**

If ABCD Partnership had a section 754 election in place, section 743(b) *would have* nominally adjusted the inside basis of the assets for the benefit of D's estate, as follows:

ABCD Partnership Balance Sheet (If a Section 754 Election Was in Effect)					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$400x	$400x	Partner A	$400x	$400x
Asset B	$200x (+$100x)	$400x	Partner B	$100x	$400x
Asset C	$200x (+$100x)	$400x	Partner C	$100x	$400x
Asset D	$200x (+$100x)	$400x	D's Estate	$400x (+$300x)	$400x
Total	**$1,000x (+$300x)**	**$1,600x**	**Total**	**$1,000x (+$300x)**	**$1,600x**

By way of illustration, if, within two years of D's death, ABCD Partnership had distributed a one-fourth interest in Assets B and C, to D's estate, the estate would hold Assets A and B with a tax basis and fair market value of $100x, respectively, as long as D's estate made the election under section 732(d). If D's estate does not make the election, as current distributions would result in the estate holding Assets A and B with a tax basis of $25x (25% of the unadjusted tax basis of $100x in each asset) and fair market value of $100x, respectively.

D's estate would prefer to be distributed Asset D, but with as much tax basis as possible. If ABCD Partnership simply distributed Asset D to the estate in a liquidating distribution, Asset D would have its basis increased to $400x under section 732(b). However, as discussed later in these materials, if the basis increase to Asset D is greater than $250,000, then there is a "substantial basis reduction,"[297] and a mandatory inside basis adjustment under section 734(b) would cause the partnership to reduce the inside basis of the remaining assets in the partnership. Furthermore, as discussed above, under section 1.6011-18 of the Treasury Regulations, this would be considered a transaction of interest (Section 732(b) TOI) if the applicable threshold is exceeded, as defined therein.

Instead, ABCD Partnership makes liquidating distributions of Asset C to Partner B and Asset B to Partner C. Partner B will hold Asset C with a tax basis of $100x and value of $400x. Partner C will hold Asset B with a tax basis of $100x and value of $400x. As discussed above, if any property for which the D's estate would have had an inside basis adjustment is distributed to another partner, the adjustment for such distributed property is reallocated to remaining partnership property.[298] In this case, inside basis adjustments that would have been made to Assets B and C will be shifted to Asset D under section 743(b), as if a section 754 election had been in effect (because Asset A has no unrealized appreciation), as follows:

ABCD Partnership Balance Sheet (If a Section 754 Election Was in Effect)					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$400x	$400x	Partner A	$400x	$400x
Asset D	$400x (+$300x)	$400x	D's Estate	$400x (+$300x)	$400x
Total	**$800x (+$300x)**	**$1,600x**	**Total**	**$800x (+$300x)**	**$1,600x**

At this point, Asset D can be distributed to D's estate within 2 years of D's death, and the estate can make an election under 732(d) to treat the property as if Asset D had its basis adjusted under section 743(b). D's estate hold Asset D with a tax basis and fair market value of $400x. Technically, because the distribution would be considered a liquidating distribution (value of the property is equal to the capital account balance of D's estate) leaving only Partner A, ABCD Partnership will be considered liquidated, with Partner A holding Asset A or owning a disregarded entity holding Asset A. It is unclear whether the distribution of Asset D to D's estate would be considered a Section 732(b) TOI (liquidating

[297] §§ 734(d) and 734(b)(2).

[298] Treas. Reg. §§ 1.743-1(g)(2) and (5), Ex. (iv).

distribution) or Section 732(d) TOI (distribution of property without a section 754 election) because both of those require an increase in tax basis. Here, Asset D, in theory, had basis equal to its resulting basis. Further, even if the liquidating distribution is considered a "substantial basis reduction," any mandatory reduction of inside basis would be immediately cured under section 732(b).

B. Section 732(d) Mandatory Basis Adjustments

5. Section 732(d) provides the IRS may, by Treasury Regulation, require the application of section 732(d) "in the case of a distribution to a transferee partner, whether or not made within 2 years after the transfer, if at the time of the transfer the fair market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership."[299] To that end, the Treasury Regulations were issued that require the application of section 732(d) when the value of partnership property exceeds 110 of the inside basis, but with two additional requirements, related to whether basis is "shifted" from non-depreciable assets (capital) to depreciable assets. Those two additional requirements, determined at the time of the acquisition of the transferred interest, are as follows:

a. "An allocation of basis under section 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance;"[300] and

b. "A basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed."[301]

6. The following example illustrates how the mandatory basis adjustment under section 732(d) would be applicable:

> **Example**: ABC Partnership is owned equally by individuals A, B, and C. ABC Partnership owns the following assets: (i) inventory[302] with an adjusted basis of $2.1 million and value of $2.4 million; and (ii) three depreciable assets each with a basis and value of $200,000 (aggregate basis and value of $600,000). C dies, and C's interest is valued, for estate tax purposes, at $1.0 million when ABC Partnership does not have a section 754 election in place. C's interest receives a basis adjustment to $1.0 million under section 1014. At the time of C's death, the fair market value of all of ABC Partnership's property is $3.0 million and the total inside basis of the partnership property is $2.7 million. The value of the property in in excess of 110% of the adjusted basis.
>
> After date of death, pursuant to the terms of the partnership agreement, ABC partnership liquidates C's interest that is owned by the C's estate for $1.0 million of property, distributing $800,000 of inventory (having an inside basis of $700,000 prior to the distribution) and one of the depreciable assets having a value of $200,000 (and inside basis of $200,000).

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[299] § 732(d) [last sentence].

[300] Treas. Reg. § 1.732-1(d)(4)(ii).

[301] Treas. Reg. § 1.732-1(d)(4)(iii).

[302] Inventory items as defined in section 751(d). This example could also include unrealized receivables, as defined in section 751(c). These are the "hot" (ordinary income) assets, as discussed in other parts of these materials.

On the first requirement, a hypothetical pro rata liquidation immediately following the transfer of the partnership interest (the death of C), C's estate would receive one-third of the inventory and one-third of each depreciable asset. As discussed above, in a liquidating distribution, section 732(b), the basis of property distributed to a liquidating partner is equal to the partner's outside basis ($1.0 million). Section 732(c)(1)(A) provides the basis of distributed properties will be allocated, first, to any unrealized receivables and inventory items "in an amount equal to the adjusted basis of each such property."[303] Then, to the extent there is any basis remaining, to other distributed properties.[304] Thus, in the hypothetical liquidation, the distributed inventory will have a basis of $700,000 and value of $800,000 and the distributed depreciable property will have a $300,000 adjusted basis (the remaining unallocated basis) and value of $200,000, in aggregate. The result is a "shift" of $100,000 of basis to depreciable property. On the second requirement, a basis adjustment under section 743(b) (if a section 754 election had been in effect) would have allocated $800,000 to the inventory. In this example, the application of section 732(d) is mandatory. The end result is C's estate receives inventory with an adjusted basis and value of $800,000 and depreciable property with an adjusted basis of $200,000.

7. The following example illustrates how the mandatory basis adjustment under section 732(d) would not be applicable:

Example: ABC Partnership is owned equally by individuals A, B, and C. ABC Partnership owns the following assets: (i) a non-depreciable capital asset with an adjusted basis of $900,000 and value of $1.5 million; and (ii) three depreciable assets each with an adjusted basis of $300,000 and value of $200,000 (aggregate basis of $900,000 and value of $600,000). C dies, and C's interest is valued, for estate tax purposes, at $700,000 when ABC Partnership does not have a section 754 election in place. C's interest receives a basis adjustment to $700,000 under section 1014. At the time of C's death, the fair market value of all of ABC Partnership's property is $2.1 million and the total inside basis of the partnership property is $1.8 million. The value of the property is in excess of 110% of the adjusted basis.

On the first requirement, a hypothetical pro rata liquidation immediately following the transfer of the partnership interest (the death of C), C's estate would receive one-third of the non-depreciable capital asset and one-third of each depreciable asset. There are no unrealized receivables or inventory items in this illustration. Under section 732(c)(1)(B)(i), the basis of distributed properties will be allocated "first by assigning to each such other property such other property's adjusted basis." So, of the $700,000 of basis available to allocate to the distributed property, $300,000 is allocated to the capital assets (value of $500,000), and $300,000 to the depreciable property (value of $200,000). As to the remaining $100,000 of basis to be allocated, the Code provides it is allocated first to properties with "unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increased (but only to the extent of each property's unrealized appreciation)."[305] In this example, the only assets with unrealized appreciation are the non-depreciable capital assets. As a result, the capital assets are allocated an

[303] § 732(c)(1)(A).

[304] § 732(c)(1)(B).

[305] § 732(c)(2)(A). This is because under section 732(c)(1)(B)(ii) there is excess remaining basis to be allocated and section 732(c)(2) allocates the increase in basis that is required.

additional $100,000 to $400,000 (value of $500,000). The end result of the hypothetical liquidation is the distributed capital assets have an adjusted basis of $400,000 and value of $500,000 and the depreciable assets have an adjusted basis of $300,000 and value of $200,000. Despite the fact depreciable property has an adjusted basis greater than fair market value, no "shift' occurs because $300,000 does not exceed the basis of the depreciable assets prior to death.[306]

In this example, the second requirement would have been met. A basis adjustment under section 743(b) (if a section 754 election had been in effect) would have allocated $500,000 to the non-depreciable capital assets and the depreciable property would have been "stepped-down" to $200,000.

C. Post-Death Distributions

1. Non-Liquidating "Current" Distributions

a. Cash Distributions May Result in Gain and Ordinary Income

(1) Unless a distribution (or a series of distributions) results in a termination of a partner's interest in a partnership, it will be considered a non-liquidating or "current" distribution.[307] Since most family-owned partnerships, commons referred to as "family limited partnerships" (FLPs) are structured as "pro rata" partnerships,[308] it is important to recognize that, generally, there is no gain or loss on pro rata current distributions regardless of the type of asset being distributed,[309] unless cash distributed exceeds the outside basis of the partnership interest of any of the partners.[310]

(2) Distributions of cash (including a reduction in a partner's share of liabilities and distributions of marketable securities)[311] to a partner reduces the partner's outside basis, with gain recognized to the extent the cash distributed exceeds outside basis.[312] No loss is ever recognized on a current distribution.[313] Any gain resulting from a current distribution of cash is considered capital gain that would result from a sale of the partner's interest.[314]

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[306] McKee, Nelson, Whitmire & Brodie, *Federal Taxation of Partnerships and Partners* (Thomson Reuters/Tax& Accounting, 5th ed. 2024, with updates through August 2024) (online version accessed on Checkpoint (www.checkpoint.riag.com) 09/10/24) ¶ 26.03, Ex. 26-3.

[307] Treas. Reg. § 1.761-1(d).

[308] This is generally due to the "same class" exception under section 2701(a)(2)(B) of the Code. With respect to this exception, the Treasury Regulations provides, "A class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability)." Treas. Reg. § 25.2701-1(c)(3).

[309] § 731(a)(1) and Treas. Reg. §§ 1.731-1 and 1.732-1(b).

[310] § 731(a)(1) and Treas. Reg. § 1.731-1(a).

[311] § 731(c) and Treas. Reg. § 1.731-2.

[312] § 733(1) and Treas. Reg. § 1.733-1.

[313] §§ 731(a)(2) and 731(b). A loss may only occur with a liquidating distribution. Treas. Reg. §1.731-1(a)(2).

[314] § 731(a).

(3) The gain may be ordinary income if the distribution results in a disproportionate sharing of certain "unrealized receivables" and "inventory items" of the partnership (section 751 assets).[315] The definitions of these types of assets (often referred to as "hot assets") include more things than might be obvious. Unrealized receivables include rights to payment for goods or services not previously included in income,[316] and recapture property, but only to the extent unrealized gain is ordinary income. "Inventory items" include any property described in section 1221(a)(1) (inventory or other property held for sale to customers in the ordinary course of business and any other property that would not result in capital gain or gain under section 1231 (accounts receivables).[317]

(4) The holding period of any gain from the distribution of cash is determined by the partner's holding period in his or her partnership interest.[318] If the partner acquired his or her partnership interest by contributing property to the partnership (typically in a nonrecognition[319] transaction), the holding period of the property transferred is added to the partnership interest's holding period.[320] If the partner acquires the partnership interest at different times, the partnership interest will have different holding periods, allocated in proportion to the fair market value of the contributed property.[321]

b. Property Distributions Are Generally Nontaxable

(1) Neither the partner nor the partnership will recognize any gain or loss upon a distribution of property,[322] unless the property is a marketable security (treated as cash)[323] or is a "hot asset" under section 751. If the distributed property is subject to indebtedness, any net change (typically an increase) in the partner's share of liability is treated as a contribution (in most cases) or a distribution of cash by the partner, and the distributed property is distributed without recognizing any gain.[324]

(2) The basis of the distributed property in the hands of the partner is based on the tax basis that the partnership had in the property prior to the distribution (the "inside basis").[325] The

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[315] § 751.

[316] § 751(b) and Treas. Reg. § 1.751-1(b)(2), (d)(1).

[317] § 751(d)(1). Inventory items will be treated as section 751(b) property if the inventory items have "appreciated substantially in value," which will exist if their "fair market value exceeds 120 percent of the adjusted basis to the partnership of such property." § 751(b)(3)(B).

[318] *See* GCM 36196 and *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948), *aff'g* 7 T.C. 1088 (1946), *cert. denied*, 334 U.S. 819 (1948).

[319] § 721.

[320] §§ 1223(1), 1223(2), and 723; Treas. Reg. §§ 1.1223-1(b) and 1.723-1.

[321] Treas. Reg. § 1.1223-3(a), (b) and (f), Ex. 1; *See* T.D. 8902, *Capital Gains, Partnership, Subchapter S, and Trust Provisions*, 65 Fed. Reg. 57092-57101 (Sept. 21, 2000).

[322] § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). Although the "mixing bowl" rules may apply to trigger gain to a partner who contributed the distributed property. §§ 704(c)(2)(B) and 737.

[323] § 731(c) and Treas. Reg. § 1.731-2.

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

[325] § 732(a)(1) and Treas. Reg. § 1.732-1(a). Note, that if a Section 754 election is in place or if the partnership had a substantial built-in loss under Section 743(d), the inside basis includes any basis adjustment allocable to the partner under Section 743(b) but only as they relate to the partner. If the distributed property is not the property that was the

basis of the distributed property will, however, be limited to the outside basis of the partner's partnership interest, as adjusted for cash distributions (reduction) and changes in liabilities because the distributed property is encumbered with debt.[326] This limitation, effectively, transfers the inherent gain in the partnership interest (outside basis) to the distributed property. When multiple properties are distributed and the outside basis limitation is triggered, the outside basis is allocated first to section 752 property and any excess to other property.[327] All other distributed property once all outside basis has been exhausted will have a zero basis.

(3) Generally speaking, the character of the distributed property in the hands of the partner will be determined at the partner level, with the exception of unrealized receivables and inventory items, as defined in section 751.[328] This provision prevents a partner from converting an ordinary income item, like inventory in the partnership's hands, into a capital asset. The holding period of the distributed property includes the holding period of the partnership.[329]

2. Liquidating Distributions

a. Cash Distributions Can Result in Gain and Loss

(1) Liquidating distributions (whether in one distribution or a series of distributions) terminate the liquidated partner's entire interest in a partnership.[330] Liquidating distributions are treated the same as current distributions except a loss may be recognized,[331] and the basis of property distributed to a partner may be increased (discussed below).[332] The only way to recognize a loss upon a liquidating transfer is if the distribution consists of (and only to the extent of): (i) cash (but not including marketable securities[333]), and (ii) the adjusted basis to the distributee partner, as determined under section 732, of "unrealized receivables" and "inventory items" as defined in section 751.[334]

(2) Most FLPs are structured as "pro rata" or single class share partnerships because of the "same class" exception under section 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, "[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except

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subject of the basis adjustment under Section 743(b), the adjustment is transferred to the distributed property in the same class (capital gain or ordinary property). Treas. Reg. § 1.755-1(a).

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

[327] § 732(c)(1)(A)(i) and Treas. Reg. § 1.732-1(c)(1)(i).

[328] § 735(a).

[329] § 735(b). Note, the holding period of the partner's interest in the partnership is generally irrelevant when determining the holding period of distributed property.

[330] § 761(d).

[331] § 731(a)(2) and Treas. Reg. § 1.731-1(a)(2).

[332] § 732(b), 732(c), and Treas. Reg. § 1.732-1(b).

[333] § 731(c)(1) refers to § 731(a)(1), the gain provision, not § 731(a)(2), the loss provision.

[334] § 731(a)(2) and Treas. Reg. §§ 1.731-1(a)(2) and 1.732-1(c)(3). If the basis to be allocated upon a distribution in liquidation of the partner's entire interest in the partnership is greater than the adjusted basis to the partnership of the "unrealized receivables" and "inventory items" distributed to the partner, and if there is no other property distributed to which the excess can be allocated, the distributee partner sustains a capital loss under § 731(a)(2) to the extent of the unallocated basis of the partnership interest.

for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability)."[335] In order to qualify for this exception, it generally requires that distributions must be made proportionately and at the same time (but not necessarily the same assets). In order to effectuate a disproportionate distribution of property to a partner, one would need to redeem a portion of the partner's interest (reduce percentage ownership) in a current distribution or liquidate the partner.

b. Basis of Distributed Property Can Increase or Decrease

(1) When property is distributed in liquidation of a partner's interest, for purposes of determining the basis in the hands of the former partner, the Code provides the basis in section 751 assets (i.e., "unrealized receivables" and "inventory items" as defined in section 751) cannot exceed the transferred basis.[336] As a result, a liquidated distributee partner's in section 751 property cannot exceed the transferred basis.

(2) The basis of other property distributed (i.e., capital assets or section 1231 assets) can be increased if the liquidated partner's outside basis (reduced by cash[337] and adjusted for any change in the partner's share of liabilities as a result of the distribution) is greater than the inside basis of the assets distributed.[338] If the transferred basis is in excess of the fair market value of the distributed asset, then a loss can be recognized on a subsequent sale or, if the property is depreciable, depletable or amortizable, the added basis can provide tax benefits in the form of increased cost recovery deductions.

(3) When multiple properties are distributed by the partnership in a liquidating distribution, the distributee partner's basis in distributed properties is limited to that partner's outside basis in the partnership interest (reduced for any money distributed. The distributee partner's outside basis is allocated to the distributed properties pursuant to section 732(c). The basis is first allocated to any "unrealized receivables" and "inventory items" as defined in section 751 but limited to the adjusted basis of those properties.[339] Any remaining outside basis is allocated to "other" distributed properties (capital assets or section 1231 assets). If the remaining outside basis is *less* than the adjusted basis of such "other" distributed properties, then the basis of the properties will be decreased, and the decrease is first applied to properties with unrealized depreciation (in proportion to their respective amounts of unrealized depreciation but only to the extent of the unrealized depreciation in each asset),[340] with any remaining decrease applied in proportion to their respective adjusted bases.[341]

(4) If the remaining outside basis is *greater* than the adjusted basis of such "other" properties, then the basis of the properties will be increased. The increase is allocated first to distributed properties with unrealized appreciation in proportion to their respective amounts of unrealized

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[335] Treas. Reg. § 25.2701-1(c)(3).

[336] § 732(c)(1)(A) and Treas. Reg. § 1.732-1(c)(1)(i).

[337] Including distributions of marketable securities and any debt obligations of the transferee. *See* Treas. Reg. § 1.731-1(c)(2).

[338] § 732(b) and Treas. Reg. § 1.732-1(b).

[339] § 732(c)(1) and Treas. Reg. § 1.732-1(c)(1)(i). If the outside basis of the distributee partner is less than the adjusted basis of the distributed "unrealized receivables" and "inventory items," then the basis is allocated according to sections 732(c)(1)(A)(ii) and 732(c)(3). *See also* Treas. Reg. § 1.732-1(c)(2)(i).

[340] §§ 732(c)(1)(B)(ii), 732(c)(3)(A), and Treas. Reg. § 1.732-1(c)(2)(i).

[341] §§ 732(c)(1)(B)(ii), 732(c)(3)(B), and Treas. Reg. § 1.732-1(c)(2)(i).

appreciation before such increase (but only to the extent of each property's unrealized appreciation).[342] Any remaining outside basis is allocated to such "other" properties in proportion to their respective fair market values.[343]

(5) The basis adjustments to the partnership are the same as discussed with current distributions, in particular, if there is a section 754 election in place. With respect to liquidating distributions, the inside basis adjustments may be increased or decreased (rather than only increased in a current distribution). This is because a liquidating distribution may result in a loss to the withdrawing partner,[344] and a property distribution may result in an increased adjusted tax basis.[345] Another difference with liquidating distributions exists when there is a substantial basis reduction. Under section 734(a), an inside basis adjustment is not required upon a distribution of property to a partner, unless a section 754 election is in place or unless "there is a substantial basis reduction with respect to such distribution,"[346] which will exist if the amount exceeds $250,000.[347] There will be a substantial basis reduction when the sum of: (i) any loss recognized by the liquidating partner, and (ii) the excess of the basis of distributed property to the liquidated partner over the partnership's transferred inside basis, exceeds $250,000. For example, if a partner with an outside basis of $2 million is distributed an asset with an inside basis of $1 million in full liquidation of his or her interest, then under section 732(b) of the Code, the partner's basis in the distributed asset is now $2 million. Because the partner's basis in the asset now exceeds the partnership's basis in the asset by more than $250,000, there is a substantial basis reduction. Consequently, the partnership must reduce the basis of its remaining assets by $1 million as if a section 754 election were in effect.[348] This is discussed in more detail below.

(6) Adjustments for the gain or loss on the partnership interest, or for distributed capital or section 1231 assets may be made only to the inside basis of capital or section 1231 assets, while adjustments to reflect a limitation on the basis of ordinary income property are allocated only to partnership ordinary income property. There may be a positive adjustment for ordinary income assets, and a negative adjustment for capital assets, or the reverse, but no positive adjustment for one capital or ordinary income asset, and negative adjustment for another.[349] Like the adjustments for current distributions, positive adjustments for a class are allocated to appreciated properties, first, in proportion to unrealized gain, and then to all properties in proportion to fair market value.[350] Similarly, reductions in partnership assets are allocated first to property that has declined in value in proportion to the unrealized loss, then to all properties in proportion to their adjusted basis.[351] This is discussed in more detail below.

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[342] § 732(c)(2)(A) and Treas. Reg. § 1.732-1(c)(2)(ii).

[343] § 732(c)(2)(B) and Treas. Reg. § 1.732-1(c)(2)(ii).

[344] § 734(b)(2)(A) and Treas. Reg. §1.734-1(b).

[345] § 734(b)(2)(B) and Treas. Reg. §1.734-1(b).

[346] § 734(a).

[347] § 734(d). The subsection refers to § 734(b)(2)(A), which in turn refers to § 731(a)(2) relating to liquidating distributions, and § 734(b)(2)(B), which refers to § 732(b) also relating to liquidating distribution.

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

[349] Treas. Reg. § 1.755-1(c)(2).

[350] Treas. Reg. § 1.755-1(c)(2)(i).

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

3. Distributions in "Mixing Bowl" Transactions

a. Generally

(1) Because both property contributions to and distributions from a partnership are generally nonrecognition events, partnerships could be used to exchange property without recognizing income despite the fact that the properties would not have qualified as a like-kind exchange under section 1031. The partnership would be treated as a "mixing bowl" where assets are commingled and then the partnership is dissolved, each partner walking away with a different mixture of assets. As a result of this perceived abuse, Congress enacted the "anti-mixing bowl" provisions of sections 704(c)(1)(B) and 737. These provisions can be triggered when contributed property is distributed to another partner or if other property is distributed to a contributing partner.

(2) Some of the techniques discussed in these materials require a distribution of partnership property to one partner (or less than all of the partners). If such property had been contributed by a partner (rather than purchased by the partnership), then these "anti-mixing bowl" rules could be implicated, possibly triggering gain to one or more of the partners. As discussed, if seven years have elapsed from contribution to distribution, then that gain can be avoided.

b. Contributed Property to Another Partner – Section 704(c)(1)(B)

(1) If contributed property is distributed within seven years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution. [352]

(2) The amount of such gain or loss will generally equal the lesser of (a) the difference between the fair market value of the contributed at the time the property was contributed and the contributing partner's basis in the contributed property, or (b) the difference between the fair market value of the contributed property and the inside basis of the partnership at the time of the distribution.[353] The reason for the latter limitation is the gain or loss is meant to be limited to the amount that would have been allocated to the contributing partner under section 704(c) had the partnership sold the asset.

(3) The character of any such gain or loss is determined by the character of the contributed property in the hands of the partnership.[354]

(4) If the contributed property is exchanged for other property in a tax-free exchange, the property received will be treated as the contributed property for the application of section 704(c)(1)(B).[355]

(5) The outside basis of the contributing partner and the inside basis of the contributed property and the "non-contributing" partner (distributee) are adjusted for any gain or loss without the need for a section 754 election.[356]

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[352] § 704(c)(1)(B).

[353] § 704(c)(2)(B)(i) and Treas. Reg. § 1.704-4(a).

[354] Treas. Reg. § 1.704-4(b).

[355] Treas. Reg. § 1.704-4(d)(1)(i).

[356] § 704(c)(1)(B)(iii) and Treas. Reg. § 1.704-4(e).

(6) With respect to transfers of partnership interests, the Treasury Regulations provide, for section 704(c) purposes, "If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built- in gain or loss proportionate to the interest transferred must be allocated to the transferee partner."[357] Specifically to contributed property distributions to another partner, the Treasury Regulations provide, "The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner."[358]

(7) Similar to the general anti-abuse provisions mentioned above, the Treasury Regulations provides that "if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B),"[359] based on all the facts and circumstances, the IRS can recast the transaction appropriately. One example given in the Treasury Regulations deals with a partnership having a nominal outside partner for a number of years, and then prior to the expiration of the (now seven years) section 704(c)(1)(B) period, adding a partner to whom it is intended the contributed property will be distributed. When the contributed property is distributed after the "mixing bowl" period has expired, the example provides that a taxable transfer is deemed to have occurred because the "mixing bowl" period is deemed to have been tolled until the admission of the intended recipient partner of the contributed property.[360]

c. Other Property Distributed to Contributing Partner – Section 737

(1) If a partner contributes appreciated property to the partnership and, within seven years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally will be required to recognize gain upon the receipt of such other property.[361] The reason for this provision is to avoid deferral of the gain that would have been allocated to the contributing partner under section 704(c) because such gain would not be triggered unless the partnership actually sold the property in a taxable transaction. If section 737 is triggered, to avoid a doubling of the gain, the subsequent distribution of the property previously contributed by the same partner does not trigger gain.[362]

(2) Unlike section 704(c)(1)(B), this provision only applies to gain, not loss. As a result, in order to recognize any loss under section 704(c), the partnership would need to sell the asset in a taxable transaction.

(3) Under section 737(a), a partner who has contributed section 704(c) property and who receives a distribution of property within seven years thereafter is required to recognize gain in an amount equal to the *lesser* of:

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[357] Treas. Reg. § 1.704-3(a)(7).

[358] Treas. Reg. § 1.704-4(d)(2).

[359] Treas. Reg. § 1.704-4(f)(1).

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

[361] §§ 704(c)(1)(B) and 737.

[362] § 737(d)(1) and Treas. Reg. § 1.737-3(d).

(a) The excess (if any) of the fair market value (other than money) received in the distribution over the adjusted basis of such partner's outside basis immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution (sometimes referred herein as the "excess distribution");[363] or

(b) The "net precontribution gain,"[364] which is the net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if, at the time of the distribution, all section 704(c) property contributed by the distributee partner within seven years of the distribution that is still held by the partnership were distributed to another partner.[365]

(4) For purposes of calculating the excess distribution, the fair market value of the distributed property is calculated according to the willing buyer, willing seller standard.[366] The value determined by the partnership will control, provided the value is reasonably agreed to by the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.[367] If the distributed property is subject to a liability, it is the gross value of the property that is used in the calculation.[368]

(5) Any portion of the property that consists of property previously contributed by the distributee partner is not taken into account in determine the amount of the partner's "net precontribution gain" or the "excess distribution."[369] In such case, the basis of the previously contributed property is computed as if such property had been distributed in a "separate and independent distribution prior to the distribution that is subject to section 737."[370]

(6) The Treasury Regulations provide, "The transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to the interest transferred."[371] The Treasury Regulation then provides, "See Section 1.704-3(a)(7) and Section 1.704-4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B)." As mentioned above, the Treasury Regulations provide for purposes of section 704(c)(1)(B) purposes, the transferee of a partnership interest is treated as a contributing partner. There is some debate as to whether a transferee under section 737 is treated as a contributing partner as specifically provided for section 704(c)(1)(B).[372] It seems, however, the consensus view is that

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[363] § 737(a)(1).

[364] § 737(a)(2).

[365] § 737(b). Other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. *See* Treas. Reg. § 1.737-1(c)(1). Further, any losses inherent in section 704(c) property contributed by the distributee partner within the preceding 7-year period are netted against gains in determining net precontribution gain. *See* Treas. Reg. § 1.737-1(e), Ex. 4(iv).

[366] Treas. Reg. § 1.737-1(b)(2).

[367] *Id.*

[368] Treas. Reg. § 1.737-1(e), Ex. 2.

[369] § 737(d)(1) and Treas. Reg. § 1.737-2(d)(1).

[370] Treas. Reg. § 1.737-3(b)(2).

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

[372] *See* Richard B. Robinson, *"Don't Nothing Last Forever"—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 302 (2003), Ellen K. Harrison and Brian M. Blum, *Another View: A Response to Richard Robinson's "'Don't Nothing Last Forever'--Unwinding the FLP to the Haunting Melodies of Subchapter K,"* 28 ACTEC J. 313 (2003), and Richard B. Robinson, *Comments on Blum's and Harrison's "Another View,"* 28 ACTEC J. 318 (2003). *See also* Paul Carman, *Unwinding the Family Limited Partnership: Income Tax Impact of Scratching*

a transferee steps in the shoes of the transferor as the contributing partner. One partnership treatise provides, "Any transferee of all or part of a contributing partner's partnership interest steps into the shoes of the contributing partner under § 737 to the extent of a proportionate part of the net precontribution gain."[373] The same authors go on to assert, "The step-in-the-shoes rule should apply for all aspects of § 737 (e.g., the exception for distributions of previously contributed property provided by Regulations § 1.737-2(d)), although the Regulation by its terms is more limited."[374] Another leading treatise provides, "… if the contributing partner transfers his interest in a transaction in which gain or loss is not recognized, the transferee should step into his shoes in order to preserve the taxation of the built-in gain."[375]

(7) The character of the gain is determined by reference to the "proportionate character of the net precontribution gain,"[376] which is to say, it is generally determined by its character in the hands of the partnership.

(8) The partner's outside basis and the partnership's inside basis in the contributed property are automatically adjusted without the need for a section 754 election.[377] Further, the basis of the distributed property is adjusted to reflect the recognized gain on the partner's outside basis.[378]

(9) Marketable securities are generally treated as money for purposes of section 737.[379] In determining "net precontribution gain" under section 737, however, marketable securities contributed to the partnership are treated as contributed property.[380]

(10) Similar to the anti-abuse guidelines under section 704(c)(1)(B), the Treasury Regulations provide that transactions can be recast if, based on all the facts and circumstances, they are "inconsistent with the purposes of section 737."[381] The deemed abusive example provided in the Treasury Regulations involves a transaction, in an intentional plan to avoid section 737, where there is a contribution of property to a partnership (under section 721) immediately before a distribution of other property to the contributing partner (who also made a previous contribution of appreciated property). Gain under section 737 would be avoided because the contribution increased the outside basis of the contributing partner. Then the partnership liquidates the contributing partner's interest in a nontaxable distribution,

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the Pre-Seven Year Itch, 96 J. Tax'n 163 (Mar. 2002) and *Shop Talk: When Is a Transferee Partner a Contributing Partner?*, 98 J. Tax'n 317 (May 2003).

[373] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, Fourth Edition (Thompson Reuters, 2017), ¶ 19.08[2][e]. The treatise goes on to assert, "The step-in-the-shoes rule should apply for all aspects of § 737 (e.g., the exception for distributions of previously contributed property provided by Regulations § 1.737-2(d)), although the Regulation by its terms is more limited."

[374] Id. at ¶ 19.08[2][e], fn. 167.

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

[376] § 737(a) [flush language] and Treas. Reg. § 1.737-1(d).

[377] § 737(c) and Treas. Reg. § 1.737-3. The increase in inside basis is allocated to property with unrealized gain of the same character as the gain recognized. *See* Treas. Reg. §§ 1.737-3(c)(3) and 1.737-3(e), Ex. 3.

[378] § 737(c)(1) and Treas. Reg. § 1.737-3(b)(1).

[379] §§ 737(c)(1), 737(e), and Treas. Reg. § 1.731-2(a).

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

[381] Treas. Reg. § 1.737-4(a).

returning the contributed property (temporarily parked in the partnership to avoid gain on the distribution of other property prior to the liquidation of the partner's interest).[382]

4. Distributions and the "Disguised Sale" Rules

a. If a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash within two years of the contribution, based on the applicable facts and circumstances, the distribution will likely cause the partner to recognize gain with respect to his or her contributed property under the "disguised sale" rules.[383] In such case, the contributing partner is treated as having engaged in a transaction with the partnership "other than in his capacity as a member of the partnership" and "the transaction shall … be considered as occurring between the partnership and one who is not a partner."[384] Thus, in this instance, the partner will recognize gain on the deemed sale of the appreciated property to the partnership, and the partnership holds the property with a cost basis and new holding period.

b. The Treasury Regulations recognize two different types of disguised sales that occur between a partner and a partnership: (i) sales of property by a partner to the partnership (the foregoing example),[385] and sales of property by the partnership to a partner.[386] The latter can occur if, for example, the partnership distributes appreciated property to a partner who, within two years of such transfer, contributes or had contributed cash to the partnership. If this is treated as a disguised sale, the partnership recognizes gain on the distributed property, which is allocated to all of the partners under section 704(b), and the purchasing partner's contribution (cash) is consideration for the property, not a contribution to the partnership. The disguised purchasing partner has a cost basis in the property, and a new holding period, instead of transferred basis and tacked holding period had it been considered a partnership distribution. As discussed later, a disguised sale transaction can occur between two partners when it is determined that a purported contribution and distribution by two partners is treated as a taxable sale of a partnership interest by one partner to the other.[387]

c. As illustrated above, if it is determined that a transfer of property by a partner to a partnership and a transfer of consideration by a partnership to the partner is a sale exchange of that property (disguised sale), then such transfers are not treated as a contribution and distribution under section 721 and 731 of the Code.[388] In such instant, purported distributions in a disguised sale are treated as payments by the partnership to the disguised seller-partner, acting in an independent capacity, and not as a partner.[389] The sale is considered to take place on that date the partnership is considered the owner of the property.[390] If the transfer of the consideration from the partnership to the partner occurs after the transfer of property to the partnership, the partner and the partnership are treated as if, on the date of the sale, the

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

[383] § 707(a)(2)(B).

[384] § 707(a)(1).

[385] *See* Treas. Reg. § 1.707-3.

[386] *See* Treas. Reg. § 1.707-6(a).

[387] § 707(a)(2)(B), flush language ("such transfers shall be treated… as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.").

[388] Treas. Reg. § 1.707-3(a)(2).

[389] § 707(a)(2) and Treas. Reg. § 1.707-3.

[390] Treas. Reg. § 1.707-3(a)(2).

partnership transferred to the partner an obligation to transfer to the partner money or other consideration at a later date.[391] If there is a difference in the amount between the contribution and the value of the property distributed that is attributable to the time between the two events, the difference is considered imputed interest.[392] If a purported contribution to a partnership is determined to be a property transferred in a disguised sale, it may result in the transferor not being considered a partner at all, and it may result in a determination that no partnership exists.[393]

d. Specifically, section 707(a)(2)(B) of the Code provides for disguised sale treatment if:

(1) "there is a direct or indirect transfer of money or other property by a partner to a partnership,"[394]

(2) "there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner),"[395] and

(3) The two transfers, "when viewed together, are properly characterized as a sale or exchange of property."[396]

e. The Code and the Treasury Regulations take a facts-and-circumstances approach to determine whether a disguised sale has occurred. The Treasury Regulations provide that simultaneous distributions are disguised sales if "the transferor money or other consideration would have been made but for the transfer of property."[397] For non-simultaneous transfers and distributions, a disguised sale occurs if the "subsequent transfer is not dependent on the entrepreneurial risks of partnership operations."[398] The Treasury Regulations provide two rebuttable presumptions in determining whether a disguised sale has occurred:

(1) If the contribution and distribution occur within a 2-year period (regardless of the order), a disguised sale is presumed to have occurred, unless the facts and circumstances "clearly establish that the transfers do not constitute a sale;"[399] and

(2) If the contribution and distribution occur more than two years apart (regardless of the order), a disguised sale is presumed not to have occurred, unless the facts and circumstances "clearly establish that the transfers constitute a sale."[400]

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[391] *Id.*

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

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

[394] § 707(a)(2)(B)(i).

[395] § 707(a)(2)(B)(ii).

[396] § 707(a)(2)(B)(iii).

[397] Treas. Reg. § 1.707-3(b)(1)(i).

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

[399] Treas. Reg. § 1.707-3(c)(1).

[400] Treas. Reg. § 1.707-3(d).

f. The Treasury Regulations provide a list of 10 factors that would tend to prove the existence of a disguised sale. Notably, the Treasury Regulations provide, "Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists."[401] The factors are:

(1) The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(2) The transferor has a legally enforceable right to the subsequent transfer;

(3) The partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(4) Any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(5) Any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

(6) The partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(7) The partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(8) Partnership distributions, allocations or control of partnership operations is designed to affect an exchange of the burdens and benefits of ownership of property;

(9) The transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(10) The partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

g. The definition of a disguised sale is written broadly enough to include transactions that would include a deemed sale of property by the partnership to one or more partners. To that end, the Treasury Regulations provide, "Rules similar to those provided in section 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner."[402] If a contribution and distribution is thus treated as a disguised sale, the partnership

[401] Treas. Reg. § 1.707-3(b)(2).

[402] Treas. Reg. § 1.707-6(a).

recognizes gain (or loss) on the property distributed that is shared by all partners, and the contribution is consideration for the property, not a contribution to the partnership. As a result, the disguised purchaser is entitled to a purchase price cost basis in the property, and a new holding period, instead of the transferred basis and tacked holding period of a partnership distribution. Furthermore, a disguised sale will not affect capital accounts, since it is not considered a partnership distribution. The Treasury Regulations also provide, "Rules similar to those provided in section 1.707-5 apply to determine the extent to which an assumption of or taking subject to a liability by a partner, in connection with a transfer of property by a partnership, is considered part of a sale."[403]

h. As mentioned, the two-year presumption of a disguised sale is a facts and circumstances test based upon the factors listed above. These factors point toward circumstances where the distribution and contribution are related or tied in such a way that disguised sale treatment is warranted. However, if the contribution and distribution have independent significance in the context of the business purpose of the partnership, then the rebuttable presumption is likely to be overcome. That being said, if practitioners proceed with any of the planning ideas discussed in these materials and if they require a distribution of property to a partner (e.g., basis strip), then practitioners should inquire whether the distributee partner contributed any money or property to the partnership within two years of the distribution and if not the case, caution against such partner making any contributions within two years of the distribution (unless necessitated for business reasons).

i. The partnership is required to disclose transfers of property that are not treated as disguised sales to a partner if they are made within two years before or after transfers of consideration by the distributee or the partnership's incurring liabilities transferred to the distributee with property.[404]

j. When a contribution by one partner, usually a new partner, is followed, or preceded, by a distribution to another partner, the transaction can be recharacterized as a disguised sale of all (but often a portion) of a partnership interest.[405] Treating a transfer of property to another partner as a distribution, rather than a sale of a partnership, is advantageous because the distributee partner can apply the entire outside basis of the partnership interest against what could be characterized as consideration for only a portion of the interest.[406] Unlike the disguised sales discussed above, a disguised sale of a partnership interest will be deemed a taxable transaction between the selling and purchasing partner, notwithstanding the involvement of the partnership.

> **Example**: AB Partnership has two partners, A and B. A has a 2/3 partnership interest in AB Partnership with an outside basis of $120x and capital account of $200x. B has a 1/3 interest in AB Partnership with an outside basis of $60x and capital account of 100x. C would like to be admitted as a partner, and C is willing to pay $100x of cash to become a

[403] Treas. Reg. § 1.707-6(b)(1).

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

[405] § 707(a)(2)(B), flush language ("such transfers shall be treated… as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.").

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

partner of AB Partnership. A would like to reduce his or her partnership interest by one-half (a 1/3 interest). If C purchased one-half of A's interest for $100x of cash, then A would recognize $40x of gain (adjusted basis of the sold partnership interest is $60x—50% of A's outside basis of $120x). C would have a 1/3 partnership interest with an outside basis of $100x, capital account of $100x, and a new holding period on the partnership interest.

Alternatively, the foregoing could be accomplished in the following steps: (i) AB Partnership distributes Asset A with an inside basis of $100x and fair market value of $100x to A; and (ii) C contributes $100x of cash to AB Partnership in exchange for an equal 1/3 interest in the partnership (A, B, and C would be equal 1/3 partners in the partnership). If the latter transaction is not recast as a disguised sale, then under sections 731 and 732: (i) A would not recognize any gain on the transaction; (ii) A would own Asset A with a basis and fair market value of $100x with a tacked holding period; and (iii) A would still have a 1/3 partnership interest with an outside basis of $20x and capital account of $100x. If the transaction is deemed to be a disguised sale, then it would be treated as a sale by A of one-half of A's partnership interest, resulting in gain to A of $40x.

5. Distributions of Marketable Securities

a. A distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property) but only for purposes of determining whether gain is recognized as a result of the distribution.[407] For these purposes, marketable securities includes financial instruments (stocks, equity interests, debt, options, forward or futures contracts, notional principal contracts and other derivatives) and foreign currencies which are actively traded.[408] In addition, the Code provides that a marketable security includes "any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities."[409] Further, the Code provides that a marketable security includes "any financial instrument the value of which is determined substantially by reference to marketable securities."[410]

b. There are a number of applicable exceptions to the foregoing treatment of distributions of marketable securities, including: (1) distributions of contributed securities to the partner who contributed them;[411] (2) distributions of securities that were not marketable when acquired by the partnership and are distributed within five years of becoming marketable;[412] and (3) distributions of securities from an "investment partnership" to an "eligible partner."[413]

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[407] § 731(c).

[408] § 731(c)(2)(A) and (C).

[409] § 731(c)(2)(B)(ii).

[410] § 731(c)(2)(B)(iii).

[411] § 731(c)(3)(A) and Treas. Reg. § 1.731-2(d)(1).

[412] § 731(c)(3)(A)(ii) and Treas. Reg. § 1.731-2(d)(1)(iii). To qualify for this exception, the security must not have been marketable on the date acquired and the entity to which the security relates must not have had any outstanding marketable securities on that date. Further, the partnership must have held the security for at least 6 months prior to the security becoming marketable, and the partnership must distribute the security within 5 years from the date the security became marketable.

[413] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

c. An "investment partnership" is defined as a partnership substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.[414] Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).[415] A partnership will not be considered engaged in a trade or business by reason of any activity undertaken as an investor, trader, or dealer in such specified investments.[416]

d. An "eligible partner" is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.[417]

e. If one of these exceptions does not apply and a distribution of marketable securities results in gain to the distributee partner, the gain is the excess of the value of the marketable securities over the partner's outside basis.[418] The amount of marketable securities treated as cash is reduced (and the potential recognized gain is reduced) by, according to the section 731(c)(3)(B) of the Code:

> (i) such partner's distributive share of the net gain which would be recognized if all of the marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, over
>
> (ii) such partner's distributive share of the net gain which is attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under clause (i).[419]

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

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

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[414] § 731(c)(3)(C)(i).

[415] § 731(c)(3)(C)(i)(I) through (VIII).

[416] § 731(c)(3)(C)(ii)(I) and Treas. Reg. § 1.731-2(e)(3)(i).

[417] § 731(c)(3)(C)(iii)(I).

[418] § 731(c)(3)(B) and Treas. Reg. § 1.731-2(a) and (j), Ex. 1.

[419] § 731(c)(3)(B)(i) and (ii).

g. Thus, the reduction applies to "all marketable securities held by the partnership" and the reduction reflects not only the marketable security distributed but also any reduction in the distributee partner's gain in all of the marketable securities. According to the preamble, when the Treasury Regulations were proposed, "This provision allows a partner to withdraw the partner's portion of appreciation in the partnership's marketable securities without recognizing gain on the transaction. As a result, section 731(c) generally applies only when a partner receives a distribution of marketable securities in exchange for the partner's share of appreciated assets other than marketable securities."[420]

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

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

i. Any unrealized loss in the marketable securities is not recognized, either by the partnership or the partner.[421]

j. The basis of distributed marketable securities when gain is recognized under section 731(c) is the basis as determined under section 732 but increased by the amount of gain recognized as a result of the distribution.[422] The basis of distributed securities when no gain is recognized will be based on the general rule of section 732 for distributions. The outside basis of the distributee partner is determined as if no gain is recognized and no adjustments to is made to the basis of the marketable security attributable to the distribution itself.[423] As a result, the distributee-partner's outside basis is reduced only by the basis of the distributed securities determined under section 732 without regard to any basis increase under section 731(c)(4) (which is reflected in the securities). The foregoing rules and resulting outside basis of the distributee-partner and in the security can be complicated:

> **Example 1**: Partnership distributes a marketable security with an inside basis of $10x and a fair market value of $50x to P, a partner, who has an outside basis of $30x and a capital account of $200x. Under section 731(c) of the Code, P is treated receiving a distribution of $50x cash, which is more than P's outside basis, and P recognizes $20x of gain. P's outside basis is not affected by the gain. The distribution of the marketable security reduces P's outside basis by $10x (inside basis of the partnership), so after the distribution, P's outside basis is $20x, and P's capital account is $150x (reduced by the fair market value of the security). The marketable security in P's hands has a resulting basis of $30x (gain is added to the basis of the security).
>
> **Example 2**: Same facts as example 1, except the marketable security has an inside basis of $40x. P recognizes $20x of gain. The inside basis of the security is higher than P's outside

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

[421] § 731(b).

[422] § 731(c)(4)(A) and Treas. Reg. § 1.731-2(f)(1)(i).

[423] § 731(c)(5) and Treas. Reg. § 1.731-2(f)(1)(ii).

basis. As a result, P's resulting outside basis is $0x, and capital account is $150x. The distribution of the marketable security results in an initial reduction of basis to $30 (limited by P's outside basis) but then the resulting gain is added to the security. The marketable security in P's hands has a resulting basis of $50x.

k. For inside basis purposes, section 734 (adjustment to inside basis when there is a section 754 election or substantial basis reduction) is applied as if no gain were recognized and no basis increase was made to the distributed securities.[424] Even if a section 754 election is in place, any gain triggered from a distribution of marketable securities will not be reflected in the inside basis of any other partnership property. However, if a section 754 election is in place, the inside basis of partnership can be adjusted for any lost basis resulting from the limitation of the basis of the marketable securities in the partner's hands to the partner's outside basis (because outside basis is not adjusted to reflect the gain, as mentioned above).[425] Therefore, for purposes of sections 733 and section 734 of the Code, a distribution of marketable securities is treated as a property distribution.

l. If the partner receives other property in addition to marketable securities in the same distribution, the reduction in outside basis due to the marketable securities (cash) is taken into account first, with any remaining basis applied against the other property distributed. [426]

m. The Treasury Regulations under section 731(c) of the Code contain an anti-abuse provision which provides generally, "The provisions of section 731 (c) and this section must be applied in a manner consistent with the purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section."[427] The provision goes on to provide three examples:[428]

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

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

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

[424] § 731(c)(5) and Treas. Reg. § 1.731-2(f)(2).

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

[426] § 731(a)(1) and Treas. Reg. § 1.731-2(f)(1)(ii), (j), Ex. 5.

[427] Treas. Reg. § 1.731-2(h).

[428] *Id.*

6. Simple Example: Choosing the Asset to "Step-Up"

Example: ABCD Partnership has four equal partners, A, B, C, and D. The partnership does not have any liabilities or items of IRD, and all of the assets in the partnership are capital assets, except for Asset C, which is depreciable. All of the assets in the partnership were contributed more than 7 years ago, so there are no "mixing bowl" or disguised sale rules implications anymore. The balance sheet of the partnership is, as follows:

ABCD Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$0x	$400x	Partner A	$0x	$400x
Asset B	$0x	$400x	Partner B	$0x	$400x
Asset C (Depreciable)	$0x	$400x	Partner C	$0x	$400x
Asset D	$0x	$400x	Partner D	$0x	$400x
Total	**$0x**	**$1,600x**	**Total**	**$0x**	**$1,600x**

D passes away. Assume the fair market value of D's interest is equal to D's capital account balance ($400x). As a result, the outside basis of the D's partnership interest gets a "step-up" to $400x. ABCD Partnership does not have a section 754 election in effect at the time of D's death. As a result, the balance sheet looks, as follows:

ABCD Partnership Balance Sheet (No Section 754 Election)					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$0x	$400x	Partner A	$0x	$400x
Asset B	$0x	$400x	Partner B	$0x	$400x
Asset C (Depreciable)	$0x	$400x	Partner C	$0x	$400x
Asset D	$0x	$400x	D's Estate	$400x (+$400x)	$400x
Total	**$0x**	**$1,600x**	**Total**	**$400x (+$400x)**	**$1,600x**

If ABCD Partnership had a section 754 election in place, section 743(b) *would have* nominally adjusted the inside basis of the assets for the benefit of D's estate, as follows:

ABCD Partnership Balance Sheet (If a Section 754 Election Was in Effect)					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$100x (+$100x)	$400x	Partner A	$0x	$400x
Asset B	$100x (+$100x)	$400x	Partner B	$0x	$400x
Asset C (Depreciable)	$100x (+$100x)	$400x	Partner C	$0x	$400x
Asset D	$100x (+$100x)	$400x	D's Estate	$400x (+$400x)	$400x
Total	**$400x (+$400x)**	**$1,600x**	**Total**	**$400x (+$400x)**	**$1,600x**

In lieu of making a section 754 election, ABCD Partnership liquidates the estate's partnership interest by distributing Asset C to the estate. As discussed above, under section 732(b), the tax basis of Asset C, now held by the estate, is increased to $400x. As a result, the estate (and its beneficiaries) get the benefit of significantly higher depreciation deductions and its corresponding income tax benefits.

As noted later in these materials, the liquidating distribution may be considered a "substantial basis reduction" requiring a mandatory basis adjustment under section 734(b). However, as also noted, this can often be cured by liquidating the entire partnership.

7. Section 734 Inside Basis Adjustments

a. Generally

(1) As noted above, the inside bases of partnership assets are not adjusted when there is a distribution of property to a partner. A distribution can create discrepancies between inside and outside basis, which in turn can create distortions in the amount of income recognized and the timing of the income. For example, if a partnership makes a liquidating distribution to a partner for cash, and the partner recognizes gain as a result of that distribution because the partner's outside basis is less than the cash distributed, that gain essentially represents the liquidated partner's share of appreciation in the partnership. Distributions of partnership property that result in a change in the tax basis of the property will also create a distortion between the tax basis in the partnership and the tax basis that is reflected in the outside bases of the partners (and adjusted bases of the property in the hands of the distributee partner).

(2) Absent an adjustment to inside basis, a subsequent sale of the partnership assets will result in that gain being allocated to the remaining partners. With a section 754 election in place, the adjustments under section 734 attempt to adjust for those types of discrepancies. Adjustments can increase or decrease the inside basis of partnership property.

Example 1: A, B, and C are equal partners in ABC Partnership, which does not have a section 754 election in place. ABC Partnership has no liabilities, its balance sheet is, as follows:

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash	$200x	$200x	Partner A	$100x	$200x
Capital Asset A	$50x	$200x	Partner B	$100x	$200x
Capital Asset B	$50x	$200x	Partner C	$100x	$200x
Total	**$300x**	**$600x**	**Total**	**$300x**	**$600x**

A's partnership interest is being liquidated. To that end, ABC Partnership distributes $200x to Partner A. A recognizes $100x of capital gain. After the liquidating distribution, B and C, the remaining partners, are equal partners, each having a 50% interest in ABC Partnership, and the balance sheet is, as follows:

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Capital Asset A	$50x	$200x	Partner B	$100x	$200x
Capital Asset B	$50x	$200x	Partner C	$100x	$200x
Total	**$100x**	**$400x**	**Total**	**$200x**	**$400x**

If ABC Partnership sells both of the capital assets, the partnership would recognize $300x in capital gain, which will be allocated equally to Partners B and C ($150x each), when, as reflected in each of their respective outside bases and capital accounts, they should only be allocated $200x ($100x each) of gain.[429]

If ABC Partnership had a section 754 election in place when Partner A interest was liquidated, section 734(b) would have adjusted the basis of the capital assets by the amount of the gain, as follows:

[429] If the partnership had sold the capital assets, the gain would increase the outside bases of their partnership interests under section 705(a) to $300x each (capital account balance of $200x). If the partnership subsequently liquidated by distributing $400x in cash,, Partners B and C would recoup the excess gain by receiving a capital loss of -$50x each (total -$100x) under section 731(a)(2). The only difference to Partners B and C is timing. Timing differences can be significant if: (i) liquidation occurs many years later; (ii) the partners do not have offsetting capital gain income in the year of liquidation to take advantage of the loss; or (iii) the partners receive property other than money, unrealized receivables, and inventory on the liquidation under section 731(a)(2).

ABC Partnership Balance Sheet with Section 754 Election					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Capital Asset A	$100x (+$50x)	$200x	Partner B	$100x	$200x
Capital Asset B	$100x (+$50x)	$200x	Partner C	$100x	$200x
Total	**$200x**	**$400x**	**Total**	**$200x**	**$400x**

As one can see, now, with the section 734(b) adjustment, the adjusted basis of the capital asset is increased to $200x, and if ABC partnership sells the capital assets, the partnership would recognize $200x in capital gain, which will be allocated equally to Partners B and C ($100x each), which is reflected in each of their respective outside bases and capital accounts.

Example 2: Same original facts in Example 1, above:

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash	$200x	$200x	Partner A	$100x	$200x
Capital Asset A	$50x	$200x	Partner B	$100x	$200x
Capital Asset B	$50x	$200x	Partner C	$100x	$200x
Total	**$300x**	**$600x**	**Total**	**$300x**	**$600x**

A's partnership interest is being liquidated. To that end, ABC Partnership distributes Capital Asset B to Partner A. The distribution of Capital Asset B is a nontaxable distribution, and Capital Asset B has its basis increased to $100x (Partner A's outside basis prior the liquidating distribution), an increase of +$50x. The balance sheet, after the distribution is, as follows:

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash	$200x	$200x	Partner B	$100x	$200x
Capital Asset A	$50x	$200x	Partner C	$100x	$200x
Total	**$250x**	**$400x**	**Total**	**$200x**	**$600x**

If ABC Partnership sells Capital Asset A, the partnership would recognize $150x in capital gain, which will be allocated equally to Partners B and C ($75x each), when, as reflected in each of their respective outside bases and capital accounts, they should be allocated $200x ($100x each) of gain.

If ABC Partnership had a section 754 election in place when Partner A interest was liquidated, section 734(b) would have adjusted the basis of Capital Asset A reduced by the amount the amount of basis increase to Capital Asset B after it was distributed, as follows:

ABC Partnership Balance Sheet with Section 754 Election					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash	$200x	$200x	Partner B	$100x	$200x
Capital Asset A	$0x (-$50x)	$200x	Partner C	$100x	$200x
Total	**$200x**	**$400x**	**Total**	**$200x**	**$400x**

As one can see, now, with the section 734(b) adjustment, the adjusted basis of the capital asset is decreased to $0x, and if ABC partnership sells the capital assets, the partnership would recognize $200x in capital gain, which will be allocated equally to Partners B and C ($100x each), which is reflected in each of their respective outside bases and capital accounts.

(3) Generally, the amount of the section 734(b) adjustment and the transaction that creates the basis discrepancy are, as follows:

(a) If a distribution of cash to a partner exceeds the partner's outside basis, the distributee partner recognizes *gain*[430] by the amount of the excess, and the partnership will *increase* the inside bases of the remaining partnership assets equal to the amount of the gain under section 734(b)(1)(A);

(b) If a partnership interest is liquidated in exchange for cash (plus unrealized receivables and inventory)[431] and the distributee partner recognizes a *loss*[432] because the distributee partner's outside basis prior to the distribution exceeds the amount of the cash (and the adjusted basis of unrealized receivables and inventory) distribution, then the partnership will *decrease* the inside bases of the remaining partnership assets equal to the amount of the gain under section 734(b)(2)(A);

(c) If a partnership interest makes an in-kind (current or liquidating) distribution of in-kind partnership property that results in a *reduction* of basis[433] to the distributed property (inside basis is greater than outside basis prior to the distribution), then the partnership will *increase* the inside basis of the remaining partnership assets equal to the decrease in basis to the property under section 734(b)(1)(B); and

(d) If a partnership interest is liquidated in exchange for a distribution of in-kind partnership property and that results in an *increase* of basis[434] to the distributed property, then

[430] *See* § 731(a)(1).

[431] Respectively defined under sections 751(c) and 751(d).

[432] *See* § 731(a)(2).

[433] *See* §§ 732(a)(2) and 732(b).

[434] *See* § 732(b).

the partnership will *decrease* in the inside basis of the remaining partnership assets equal to the increase in basis to the property under section 734(b)(2)(B).

(4) In the context of the death of a partner and an adjustment to outside basis under section 1014, as noted in the previous section of these materials, a "step-up" or "step-down" in basis can create an inside/outside basis discrepancy.

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

(1) Despite their similarities, there are a number of important distinctions between the inside basis adjustments upon a transfer of a partnership interest under section 743(b) and the adjustments upon a distribution of partnership property under section 734(b). Generally, a distribution triggers a *possible* (depending upon whether the partnership has a section 754 election in effect or if there is a substantial basis adjustment requiring a mandatory inside basis adjustment) section 734(b) adjustment whenever the distributee recognizes gain or loss, or takes a basis in the distributed property different from that which the partnership had in the property.

(2) Unlike adjustments under section 743(b), adjustments under section 734(b) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee). Section 734(b)(1) and (2) provides that increases or decreases are made to "partnership property."[435]

(3) As mentioned above, adjustments under section 743(b) are not reflected in the capital accounts of the transferee partner or on the books of the partnerships.[436] On the other hand, adjustments under section 734(b) result in corresponding adjustments to capital accounts.[437]

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

(a) With a current distribution, only gain (not loss) can be recognized to a distributee partner. As such, an adjustment under section 734(b) is triggered when a distributee partner recognizes a gain on distribution of money in excess of outside basis. The amount of gain results in a corresponding increase in the inside basis of partnership property.[438]

(b) With a current distribution, when partnership property (other than money) is distributed, the basis of the property in the hands of the partner is the *lesser* of the inside basis of the property or the distributee partner's outside basis (after reducing outside basis by any money distributed).[439] When the distributee partner's outside basis is less than the inside basis of the distributed property, then the basis of the property is reduced. The amount of "lost" basis results in a corresponding increase in the remaining inside basis of partnership property.[440]

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[435] § 734(b)(1) and (2).

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

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

[438] § 734(b)(1)(A).

[439] § 732(a)(1) and (2).

[440] § 734(b)(1)(B)

(c) Unlike current distributions, a distributee partner can recognize a loss on a liquidating distribution. Thus, on a liquidating distribution, the inside basis adjustment can increase the basis of partnership (for a gain) or decrease the basis of partnership property (for a loss).[441]

(d) Further, unlike a current distribution, when partnership property (other than money) is distributed in a liquidating distribution, the basis of the property can be increased if the liquidated partner's outside (after reducing outside basis by any money distributed) is greater than the inside basis of the asset distributed.[442] The inside basis of the property has its basis replaced by the outside basis of the liquidated partnership interest.[443] If liquidated property has its basis increased, then the inside basis adjustment would correspond to a reduction of inside basis of remaining partnership property under section 734(b)(2)(B) of the Code.

(e) For liquidating distributions, unlike current distributions, there is a mandatory inside basis adjustment when there is a "substantial basis reduction with respect to a distribution of partnership property.[444] This would occur if the partner recognized a loss of more than $250,000 upon liquidation, or the basis of liquidated property is increased by more than $250,000. Either of these events would require the partnership to reduce the basis of its remaining assets under section 734(b) of the Code by the total amount of the loss or basis increase even if a section 754 election was not in place. This is discussed in more detail below.

c. Section 743(b) Inside Basis Adjustments and Section 704(c)

(1) Because section 743(b) adjustments are a function of the distributee partner's outside basis (rather than a share of the inside basis in partnership assets), the adjustments under section 734(b) does not take section 704(c) allocations into account. As a result, the adjustments to basis can inadvertently affect the section 704(c) allocations.

> **Example:** ABC Partnership has three equal partners, A, B, and C. A contributed Capital Asset A with a basis of $40x and value of $100x, B contributed Capital Asset B with a basis of $200x and value of $100x, and C contributes $100x in cash.

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash	$100x	$100x	Partner A	$40x	$100x
Capital Asset A	$40x	$100x	Partner B	$200x	$100x
Capital Asset B	$200x	$100x	Partner C	$100x	$100x
Total	**$340x**	**$300x**	**Total**	**$340x**	**$300x**

> Assuming all of the contributions were made more than 7 years ago and no changes in value, if ABC Partnership liquidates C by distributing Capital Asset A to Partner C. Under

[441] § 734(b)(1)(A) and (2)(A).

[442] § 732(b) and Treas. Reg. § 1.732-1(b).

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

[444] § 734(a), (b), and (d).

section 732(b), Asset A has its basis increased to $100x from $40x. resulting, assuming no section 754 election in place, as follows:

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash	$100x	$100x	Partner A	$40x	$100x
Capital Asset B	$200x	$100x	Partner B	$200x	$100x
Total	**$300x**	**$200x**	**Total**	**$240x**	**$200x**

With a section 754 election in place, under section 734(b)(2)(B), the basis of the remaining partnership property will be decreased (just Capital Asset B, in this instance, because the only other asset in the partnership is cash) by -$60x, with the result, as follows:

ABC Partnership Balance Sheet with Section 754 Election					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash	$100x	$100x	Partner A	$40x	$100x
Capital Asset B	$140x (-$60x)	$100x	Partner B	$200x	$100x
Total	**$240x**	**$200x**	**Total**	**$240x**	**$200x**

Had the partnership sold Capital Assets A and B, section 704(c) would have allocated $50x of gain to Partner A and -$100x of loss to Partner B. The liquidating distribution described above, with a section 754 election in place frees A from the built-in gain in Capital Asset A, and the section 734(b) adjustment reduces Partner B's built-in loss from -$100x to -$40x.[445]

(2) Another example of how section 734(b) can affect section 704(c) property is:

Example: ABC Partnership has three equal partners, A, B, and C. A contributed Capital Asset A with a basis of $40x and value of $100x, B contributed Capital Asset B with a basis of $40x and value of $100x, and C contributes $100x in cash.

[445] *See* Treas. Reg. § 1.755-1(c).

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash	$100x	$100x	Partner A	$40x	$100x
Capital Asset A	$40x	$100x	Partner B	$40x	$100x
Capital Asset B	$40x	$100x	Partner C	$100x	$100x
Total	**$180x**	**$300x**	**Total**	**$180x**	**$300x**

More 2 years later and assuming and no changes in value, if ABC Partnership distributes $50x of cash to Partner A, triggering $10x of gain under section 731(a) and reducing Partner A's interest to 20%. Assuming, assuming no section 754 election in place, as follows:

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash	$50x	$50x	Partner A	$0x	$50x
Capital Asset A	$40x	$100x	Partner B	$40x	$100x
Capital Asset B	$40x	$100x	Partner C	$100x	$100x
Total	**$130x**	**$250x**	**Total**	**$140x**	**$250x**

With a section 754 election in place, under section 734(b)(1)(A), the basis of the remaining partnership property will be increased by $10x. As discussed below, under section 755, that increase is allocated equally between Capital Assets A and B, as follows:

ABC Partnership Balance Sheet with Section 754 Election					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Cash	$50x	$50x	Partner A	$0x	$50x
Capital Asset A	$45x (+$5x)	$100x	Partner B	$40x	$100x
Capital Asset B	$45x (+$5x)	$100x	Partner C	$100x	$100x
Total	**$140x**	**$250x**	**Total**	**$140x**	**$250x**

The result is that the section 734(b) adjustment reduced the amount of section 704(c) gain that would be allocated to Partners A and B, if Capital Assets A and B are sold, by $10x, reducing the gain to each partner by -$5x each.

d. Allocating 734(b) Inside Basis Adjustments under Section 755

(1) In contrast with the hypothetical sale approach used for section 743(b) adjustments, the Treasury Regulations under section 755 allocate the section 734(b) adjustments on the transaction that triggers the adjustment (e.g., gain or loss upon a distribution of cash or change in the basis of an asset upon distribution to a partner). If the adjustment is caused by the recognition of gain or loss to the distributee, the section 734(b) adjustment can only be applied to capital gain property.[446] If, on the other hand, the adjustment is caused by a change in the basis of any asset within a particular class (ordinary income property or capital gain property), then the adjustment must be assigned only to assets in the same class.[447] If the partnership has no assets in the appropriate class, the adjustment is deferred until the partnership acquires an asset in that class.[448]

(2) Once the adjustment is assigned to the appropriate class, positive adjustments (increases to the basis of partnership property) are first allocated to assets with unrealized appreciation in proportion to their relative appreciation. Once all of the unrealized appreciation has been eliminated, then the remaining amount is divided among the properties of the class in proportion to their relative fair market values.[449] Negative basis adjustments are allocated first to assets within the relevant class which have unrealized depreciation in proportion to their relative unrealized depreciation. Once all of the unrealized depreciation has been eliminated, then the adjustment is allocated among all assets in the class in proportion to their adjusted basis (not fair market value).[450] The inside basis of property cannot be reduced below zero.[451]

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

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

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

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

[447] Treas. Reg. § 1.755-1(c)(1)(i).

[448] Treas. Reg. § 1.755-1(c)(4).

[449] Treas. Reg. § 1.755-1(c)(2)(i).

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

[451] Treas. Reg. § 1.755-1(c)(3).

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

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

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

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

e. Section 734(b) Adjustments to Cost Recovery Property

(1) If section 734(b) increases the inside basis of cost recovery property, the Treasury Regulations provide:[452]

> For purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the distribution of property to a partner, then the increased portion of the basis must be taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase.

(2) If the basis of cost recovery property is decreased, the decrease is accounted for over the remaining recovery period of the affected property, beginning with the recovery period during which the distribution occurs.[453]

[452] Treas. Reg. § 1.734-1(e)(1).

[453] Treas. Reg. § 1.734-1(e)(2).

(3) If the basis of depletable property is changed under section 734(b), the change is taken into account in computing the depletion allowance for the property.[454] In the case of oil and gas property, the basis adjustment is made at the partner level.[455]

f. Mandatory Inside Basis Adjustment: Substantial Basis Reduction

(1) Even in the absence of a section 754, the Code provides that a partnership must make mandatory inside basis adjustments when there is a distribution of property that results in a "substantial basis reduction" with respect to the distribution (requiring a mandatory basis adjustment under section 734(b) of the Code).[456]

(2) A "substantial basis reduction" is deemed to occur when upon a distribution of property there is any loss to the distributee partner or an increase in the basis of the distributed property to the distributee partner (or a combination of the two) that exceeds $250,000.[457] In other words, if there had been a section 754 election in place, a distribution under these circumstances would have resulted in a negative inside basis adjustment that exceeds $250,000. As discussed above, losses to the partner and increases to the basis of distributed property only occur on liquidating distributions (not current distributions).

Example 1: ABC Partnership has three equal partners, A, B, and C. The partnership does not have any liabilities. The balance sheet of the partnership is as follows:

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$200,000	$500,000	Partner A	$200,000	$500,000
Asset B	$100,000	$500,000	Partner B	$100,000	$500,000
Asset C	$500,000	$500,000	Partner C	$500,000	$500,000
Total	**$800,000**	**$1,500,000**	**Total**	**$800,000**	**$1,500,000**

The partnership liquidates C's interest by distributing Asset B to C. Because C's outside basis is $500,000, Asset B has its basis increased by $400,000 (from $100,000 to $500,000). This causes the partnership to have $400,000 more inside basis than the remaining partners (A and B) have in outside basis ($300,000), as illustrated below.

[454] *See* Treas. Reg. 1.612-1(a).

[455] Treas. Reg. § 1.603A-3(e)(6)(iv).

[456] § 734(a)(1).

[457] §§ 734(d) and 734(b)(2).

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$200,000	$500,000	Partner A	$200,000	$500,000
Asset C	$500,000	$500,000	Partner B	$100,000	$500,000
Total	**$700,000**	**$1,000,000**	**Total**	**$300,000**	**$1,000,000**

A "substantial basis reduction" is deemed to have occurred, requiring the partnership, even in the absence of a section 754 election, to decrease the adjusted basis of partnership property under section 734 by $400,000, as follows:

ABC Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$85,714	$500,000	Partner A	$200,000	$500,000
Asset C	$214,286	$500,000	Partner B	$100,000	$500,000
Total	**$300,000**	**$1,000,000**	**Total**	**$300,000**	**$1,000,000**

Example 2: A and B are two equal partners in AB Partnership. The partnership does not have any liabilities and owns two capital assets. Asset A is a capital asset that has an adjusted basis and fair market value of $600,000. Asset B is a depreciable asset with no basis and fair market value of $600,000. Neither of the assets were contributed to the partnership. Partner A dies. At the time of death, the partnership balance sheet is, as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$600,000	$600,000	Partner A	$300,000	$600,000
Asset B (Depreciable)	$0	$600,000	Partner B	$300,000	$600,000
Total	**$600,000**	**$1,200,000**	**Total**	**$600,000**	**$1,200,000**

The estate values A's interest at $600,000 (liquidation value). AB Partnership does not have a section 754 election in place. The partnership interest has its outside basis adjusted under section 1014 to $600,000, as follows:

AB Partnership Balance Sheet					
Assets			**Capital Accounts**		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	$600,000	$600,000	A's Estate	$600,000	$600,000
Asset B (Depreciable)	$0	$600,000	Partner B	$300,000	$600,000
Total	**$600,000**	**$1,200,000**	**Total**	**$900,000**	**$1,200,000**

After the death of Partner A, AB Partnership liquidates the partnership, distributing Asset B to A's estate and Asset A to Partner B. As a result, Asset B has its basis increased from $0 to $600,000. A "substantial basis reduction is deemed to have occurred. Even in the absence of a section 754 election, the partnership must temporarily reduce the inside basis of Asset A from $600,000 to $300,000. When AB Partnership distributes Asset A to Partner B in a liquidating distribution, its Asset A will have $300,000 of basis (the amount of basis Partner B should have, as reflected in B's outside basis. The net effect is to give A's estate (and its beneficiaries) a depreciable asset that is flush with tax basis. Whereas if a section 754 election had been in place, Asset B would have its inside basis increased to $300,000.

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

1. Background

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

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

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

2. "Staggering Distributions" with No Section 754 Election

a. When a decedent's partnership interest is included in the gross estate, the estate will often claim a valuation discount for lack of marketability and control. This is often the case with estates when estate tax is payable (i.e., the gross estate exceeds the decedent's Applicable Exclusion Amount and there is no ability to "zero-out" the estate tax with the marital deduction because there is no surviving spouse). The valuation discount represents a 40% Federal estate tax savings, which is typically greater than the income tax savings from a basis adjustment under section 1014 of the Code (i.e., 20% for

capital assets and 37% for ordinary income assets). As a result, the "step-up" in basis to the partnership interest is reduced by the valuation discount, which in turn, reduces the inside basis adjustment under section 743(b), if the partnership has a section 754 election in place.

> **Example 1**: A and B form AB Partnership. A contributes shares of a publicly-traded company Z (Stock Z), which have a fair market value of $10 million and an adjusted basis of zero, in exchange for a 50% interest in AB Partnership. B contributes Stock Z shares, which have a fair market value of $10 million and an adjusted basis of $4 million, in exchange for a 50% interest in AB Partnership. Although AB Partnership would be considered an "investment company" under sections 721(b) and 351(e), the contributions to the partnership does not result in diversification. Thus, the contribution does not result in gain recognition and under section 721(a), A receives a partnership interest that has an outside basis of zero and a capital account of $10 million. B receives a partnership interest that has an outside basis of $4 million and a capital account of $10 million.
>
> Soon thereafter, A passes away. On date of death, the value of Stock Z has not changed. The fair market value of A's partnerships interest is appraised at $7 million, due to a 30% valuation discount. The partnership makes a section 754 election to make a corresponding inside basis adjustment under section 743(b) to the assets in the partnership.
>
> Under section 743(b)(1), A's estate (the transferee) is entitled to an increase in partnership inside basis equal to the "excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property." The estate's basis in the partnership interest, under section 1014, is "the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent."[458] As a result, since there are no liabilities or IRD in this example, the estate's basis in the partnership interest is $7 million.
>
> A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities.[459] There are no partnership liabilities. The partner's previously taxed capital, in this example, is the amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets, *decreased* by the amount of tax gain that would be allocated to the partner on the hypothetical transaction.[460] The amount the estate would receive in the hypothetical sale, in this example, is $10 million (A's capital account balance at death), and the amount of gain that would be allocated to the estate is $10 million. The latter is due to the fact that A contributed shares of Stock Z when it was (and still is) worth $10 million, and under section 704(c), all of that gain must be allocated to A's estate, as transferee. The hypothetical gain attributable to the other assets (the shares of Stock Z contributed by B) in the partnership are allocated to B under section 704(c). As a result, the estate's previously taxed capital (and proportionate share of the adjusted basis of the partnership property) is zero ($10

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

[459] Treas. Reg. § 1.743-1(d)(1).

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

million minus $10 million). The excess of the basis to the estate (the transferee) is $7 million ($7 million minus zero), As a result, under section 743(b)(1), the increase in inside basis is equal to $7 million.

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

b. In the foregoing example, the result is that the Stock Z contributed by A before date of death has its basis increased from zero to $7 million. If the partnership subsequently distributes the basis-adjusted Stock Z to A's estate, under the Treasury Regulations, A's estate will get the benefit of that upward basis adjustment, [461] but B would not, if any shares of the Stock Z contributed by A were to be distributed to B.[462]

Example 1 (Continued): The partnership distributes the shares of Stock Z to A's estate, and the estate in turn distributes the stock to C, the sole beneficiary of A's estate. The partnership distribution to the estate will not be a taxable event even though the distributed property is a marketable security, which normally would be considered money under section 731(c) for determining whether gain is recognized as a result of the distribution. The partnership, in this example, qualifies as an "investment partnership" under section 731(c)(2)(C), which is excepted from the rule under section 731(c). Even if the partnership did not qualify as an "investment partnership," because the partnership only holds marketable securities, it would be entitled to a full reduction of the gain under section 731(c)(3)(B) and the Treasury Regulations thereunder, as discussed earlier in these materials.[463]

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

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

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

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

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

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

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

Instead of a liquidation of the estate's interest in the partnership, for a significant non-tax reason, the partnership distributes $5 million of Stock Z to the estate in a non-liquidating (current) distribution that reduces the estate's interest in the partnership. Under section 732(a)(1), the estate now holds shares of Stock Z with an adjusted basis of zero and value of $5 million. The estate's remaining interest in the AB Partnership with an outside basis of $7 million and a capital account of $5 million. The estate distributes the $5 million of Stock to C, and C donates the stock to charity.

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

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

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

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

e. In example 2 above, the partnership terminated and liquidated. The implication is that the remaining shares of Stock Z contributed by B will be distributed to B. The ultimate result is the Stock Z will be returned to B with an adjusted basis of $4 million and fair market value of $10 million. If only the estate's partnership interest was liquidated and the entity had remained in existence and taxed as partnership, the remaining assets in the partnership would have to reduce inside basis by $2 million, even in the absence of a section 754 election. As noted herein, partnerships must make mandatory basis adjustments under section 734(b) if there is a distribution of property that results in a "substantial basis reduction" with respect to the distribution.[464] A "substantial basis reduction" is deemed to occur when, upon a distribution of property, there is any loss to the distributee partner or an increase in the basis of the distributed property to the distributee partner (or a combination of the two) that exceeds $250,000.[465] In other words, if there had been a section 754 election in place, a distribution under these circumstances would have resulted in a negative inside basis adjustment that exceeds $250,000. As discussed above, losses to the partner and increases to the basis of distributed property only occur on liquidating distributions (not current distributions). In example 2, a liquidation of the estate's partnership interest results in a basis increase in the basis of Stock Z of $2 million (from $5 million to $7 million). As a result, the basis of the partnership assets (the Stock Z contributed by B) would have its basis reduced by from $4 million to $2 million. This basis reduction can be cured by liquidating B's interest with the Stock Z. The liquidation of B's interest ($4 million of outside basis) with the shares B contributed would result in the Stock having its adjusted basis restored to $4 million.

[464] § 734(a)(1).

[465] §§ 734(d) and 734(b)(2).

f. Of course, if C, in the example above, intends to sell and diversify out of $10 million of Stock Z (100% of the stock), there would be no difference between an inside basis adjustment under section 743(b) or the "staggering distributions." In both circumstances, C would recognize $3 million of long-term capital gain, On the other hand, if C plans to sell less than $10 million of Stock Z, the "staggering distributions" option is a better alternative. For example, if C plans to sell $7 million of Stock Z, with the section 743(b) inside basis adjustment, C would recognize $2.1 million of long-term capital gain ($7 million of Stock Z with an adjusted basis of $4.9 million). With the "staggering distributions," C would not recognize any capital gain. Further, even if C has no charitable intent, C might hold on to the remaining $3 million of Stock Z with an adjusted basis of zero, anticipating a "step-up" in basis under section 1014 upon C's passing. What if C, in this example, is actually two different trusts, one of which is a marital deduction trust that will be included in the surviving spouse's estate and the other is a "credit shelter" trust that will not be included in the surviving spouse's estate. If the executor of A's estate had the authority, could the executor "pick and choose" to fund the marital trust with $3 million of Stock Z with and adjusted basis of zero and then fund the "credit shelter" trust with $7 million of Stock Z with an adjusted basis of $7 million?[466]

IV. SECTION 2036: INSIDE/OUTSIDE BASIS CONUNDRUM

A. Generally

1. When property is included under section 2036(a) of the Code, the amount of inclusion is not the value of the specific interest subject to the to the retained interest[467] or the control of the transferor.[468] Rather, the amount of inclusion is the fair market value of the property that was subject to the retained interest or power that caused inclusion under section 2036(a).[469] In the context of a partnership, this means the assets in the partnership are subject to estate tax inclusion, and under section 1014(b)(9), it appears that the inside basis of the partnership assets are adjusted to fair market value.[470]

2. If partial consideration was received at the time of the original transfer, the amount of inclusion under section 2036(a) is reduced by section 2043(a) which provides, in pertinent part, if any transfer or power described in section 2036 "is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent."[471]

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

[467] If inclusion is due to section 2036(a)(1) of the Code.

[468] If inclusion is due to section 2036(a)(2) of the Code.

[469] *See* 2036(a).

[470] "In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939." §1014(b)(9).

[471] § 2043(a).

3. If the decedent owns an interest in the partnership on the date of death, the outside basis of the partnership interests will get a basis adjustment to fair market value, but such value may include valuation discounts. The result is that the inside basis of the assets will likely be higher than the outside basis. This disparity will eventually cause the partners to either lose basis (or recognize gain) because, the basis of distributed property, whether due to a current or liquidating distribution of property, will be limited to the outside basis of the distributee partner (which in this case will be lower than the inside basis of the partnership property). There does not seem to be any mechanism in subchapter K to adjust outside basis when there is this type of inside basis discrepancy.

4. If the partnership has a section 754 election in place, then under section 743(b)(2), the adjusted basis of the partnership property will be reduced by the "excess of the transferee partner's proportion share of the adjusted basis of the partnership property over the basis of his interest in the partnership."[472] This will cause a reduction of inside basis, but not change the amount of inclusion. As discussed herein, the reduction in inside basis only applies to the transferee partner, and as a result the transferee partner will be allocated more gain than the other partners if partnership property is sold for a gain.

5. These inside and outside basis discrepancies become even more extreme when there is estate tax inclusion under section 2036, but the partnership interests are not included in the estate. Quite often clients gift or sell (i.e., to a grantor trust in exchange for an installment note) partnership interests during their lifetimes. As discussed herein, these assets will not get a basis adjustment under section 1014. This issue is discussed in more detail below.

B. Amount of Inclusion: *Powell* and *Moore*

1. The *Powell* Opinion

a. In *Estate of Powell v. Commissioner*,[473] the decedent's son, acting under a power of attorney for the benefit of the decedent, contributed $10 million of cash and securities to a family limited partnership (FLP) in return for 99% limited partnership interest. The decedent's two sons contributed unsecured promissory notes to the FLP in exchange for a 1% general partnership interest. The son, acting under the power of attorney, contributed the 99% limited partnership interest to a lifetime charitable lead annuity trust (CLAT) that would pay an annuity amount to charity for the lifetime of the decedent with the remainder passing to the decedent's sons at the death of the decedent. The son may not have had the authority to make the transfer to the CLAT because the power of attorney only allowed gifts to the principal's issue up to the federal gift tax annual exclusion. The value of the taxable gift of the remainder interest to the sons was calculated with a 25% valuation discount on the limited partnership interest due to lack of control and marketability. The decedent died 7 days after the contribution to the CLAT.

b. The IRS argued that the $10 million of contributed assets were includible in the decedent's estate under the following Code sections: (i) section 2036(a)(1) (retained enjoyment of income); (ii) section 2036(a)(2) (retained right in conjunction with any person to designate who could enjoy the property or its income; (iii) section 2038 (power to alter, amend, revoke, or terminate the transfer at the decedent's death; and (iv) section 2035(a) (transfer of property within three years of death that otherwise would have been includible sections 2036-2038 of the Code or section 2042 (inclusion of life insurance proceeds). Interestingly, the taxpayer did not contest the application of section 2036(a)(2) or argue that the bona fide transfer for full and adequate consideration exception to section 2036 applied. Rather, the

[472] § 743(b)(2).

[473] *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017).

taxpayer contended that section 2036 and 2038 could not apply because the decedent did not own any interest in the FLP at death.

c. The Tax Court agreed that section 2036(a)(2) applied. In the majority opinion, the Tax Court held that (i) the decedent, in conjunction with all other partners, could dissolve the partnership, and (ii) the decedent, through her son acting under the power of attorney and as a general partner of the FLP, could control the amount and timing of distributions. In previous cases, the courts had applied section 2036(a)(2) to certain FLP cases,[474] but this was the first application of section 2036(a)(2) where the decedent exclusively owned a limited partnership interest.

d. The majority opinion goes on to explain that the inclusion amount under section 2036 must be adjusted under section 2043(a) of the Code. Although the majority opinion admits that "read in isolation" section 2036(a)(2) would require that the amount includible in the estate would be the full date of death value of the cash and securities transferred to the FLP, it asserts that section 2036(a)(2) must be read in conjunction with section 2043(a) of the Code.

(1) Section 2043(a) of the Code provides, in pertinent part, if there is a transfer of an interest includible under section 2036 "for a consideration in money or money's worth, but is not a bona fide sale for adequate and full consideration in money or money's worth,"[475] then the amount includible in the gross estate is "only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent."[476]

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

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

> Changes in the value of the transferred assets would affect the required inclusion because sec. 2036(a) includes in the value of decedent's gross estate the date-of-death value of those assets while sec. 2043(a) reduces the required inclusion by the value of the partnership interest on the date of the transfer. To the extent that any post-transfer increase in the value of the transferred assets is reflected in the value of the partnership interest the decedent received in return, the appreciation in the assets would generally be subject to a duplicative

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[474] *See Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd*, 417 F.3d 468 (5th Cir. 2005) and *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209 (both cases involved a decedent owning a general partnership interest). *But see Kimball v. U.S.*, 371F.3d 257 (5th Cir. 2004), *rev'g*, 244 F. Supp 2d 700 (N.D. Tx. 2003) and *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74.

[475] § 2043(a).

[476] *Id.*

transfer tax. (Conversely, a post-transfer decrease in value would generally result in a duplicative reduction in transfer tax.)[477]

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

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

> This is where I part company with the Court, because I do not see any "double inclusion" problem. The decedent's supposed partnership interest obviously had no value apart from the cash and securities that she allegedly contributed to the partnership. The partnership was an empty box into which the $10 million was notionally placed. Once that $10 million is included in her gross estate under section 2036(a)(2), it seems perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities.
>
> This is the approach that we have previously taken to this problem. *See Estate of Thompson*, 84 T.C.M. (CCH) at 391 (concluding that the decedent's interest in the partnership had no value apart from the assets he contributed to the partnership); *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, 83 T.C.M. (CCH) 1641, 1654; cf. *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1020 (1963) (holding that a decedent's retained interest in her own property cannot constitute consideration under section 2043(a)). And this is the approach that I would take here. There is no double-counting problem if we read section 2036(a)(2), as it always has been read, to disregard a "transfer with a string" and include in the decedent's estate what she held before the purported transfer—the $10 million in cash and securities.
>
> Rather than take this straightforward path to the correct result, the Court adopts as the linchpin of its analysis section 2043(a). Neither party in this case advanced any argument based on section 2043(a); indeed, that section is not cited in either party's briefs. And as the Court recognizes, *see* op. Ct. p. 28, we have not previously applied section 2043(a), as the Court does here, to limit the amount includible in a decedent's gross estate under section 2036(a). *See, e.g.*, *Estate of Harper*, 83 T.C.M. (CCH) at 1654 (ruling that section 2043(a) "is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration"). [478]

f. While asserting that section 2043(a) is inapplicable in this case, the concurring opinion goes on to opine that even if section 2043(a) did apply, it is not clear that the decedent's partnership interest (the result of a now disregarded transfer) can constitute consideration in money or money's worth within the meaning of section 2043(a).

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[477] *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), fn. 7.

[478] *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), concurring opinion.

g. The *Powell* majority opinion was not joined by a majority of the Tax Court judges. Eight judges represented the majority opinion, seven judges agreed with the result but rejected the double inclusion issue, and two judges concurred with the result only.

2. The *Moore* Opinion

a. In *Estate of Moore v. Commissioner*,[479] the Tax Court held that section 2036(a)(1) applied to assets that the decedent (Mr. Moore) had transferred to a limited partnership four months before his death after he had been admitted to hospice care. The primary asset in question was a family farming business that the decedent was in the process of selling when he became ill. The decedent transferred 80% of the family farming business to the "Moore FLP," in return for a 95% limited partnership interest, and the other 20% was owned by the decedent's living trust. A Management Trust (two of his children were the co-trustees) was the 1% general partner of the Moore FLP. The decedent's 4 children collectively owned the other 4% of limited partnership interests. A few months later, the family farm business was sold for $16.5 million, and the proceeds were split among the Moore FLP and living trust according to their respective 80% and 20% interests in the business.

b. After the sale, Mr. Moore made a series of transfers of the proceeds including (i) $220,000 to the estate planning attorney payable by the Moore FLP and revocable trust; (ii) $500,000 "advances" to each of the decedent's four children from the Moore FLP; (iii) $500,000 gift to Mr. Moore's grandson, and (iv) $2 million non-pro rata distribution from the Moore FLP to the living trust to pay various expenses of the decedent including the resulting income tax liability from the sale of the business.

c. Soon thereafter, the living trust sold its 95% limited partnership interest in Moore FLP to an IDGT for $5.3 million based on the partnership's net asset value less a 53% valuation discount. The IDGT purchased the partnership interest with $500,000 gifted from the living trust and promissory notes. Later that month, Mr. Moore passed way.

d. In coming to its conclusion, the Tax Court applied the *Estate of Bongard*[480] test which provides section 2036(a)(1) applies to a transfer of a partnership interest if: (i) a transfer of assets was made to a partnership; (ii) the transfer was not a bona fide sale for adequate and full consideration; and (iii) the decedent retained an interest or right in the transferred property. The court concluded there was not sufficient evidence of legitimate and significant non-tax reasons for the establishment of the partnership and the transfer of the assets. As a result, the transfer was not a bona fide sale. Further, the court concluded Mr. Moore had retained an interest in the transferred assets as evidenced by his continued occupancy of the property, his use of the proceeds from the sale for his personal needs, and his unchanged relationship with the transferred as he had *de facto* control over the management of the partnership.

e. The Tax Court then revisited the partial consideration offset under section 2043(a) that was addressed in *Estate of Powell*, which must be part of the calculus now. As explained by the court:[481]

> Until recently, our analysis of the estate's situation could end here. Our finding that the transfer of most of the farm to the FLP didn't change its inclusion in Moore's gross estate would just mean that the proceeds from the farm's sale to the Mellons would be included

[479] *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40.

[480] *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005).

[481] *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40, at 15-16.

in Moore's gross estate, and that the value of the interest in the FLP attributable to the contribution would be excluded. *See, e.g.*, *Estate of Thompson*, 84 T.C.M. (CCH) at 391. Excluding the value of the partnership interest from Moore's gross estate might appear to be the right result because it would prevent its inclusion in the value of the estate twice. The problem is that there is nothing in the text of section 2036 that allows us to do this. Nothing in section 2036 allows us to exclude anything from the estate, only to include the value of the transferred property.

But then we decided *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017). We discovered and analyzed there, apparently for the first time, section 2043(a) of the Code as it applies to family limited partnerships. In *Estate of Powell v. Commissioner*, 148 T.C. at 404 , the taxpayer had transferred assets with a value of $10 million to a limited partnership in exchange for a 99% interest in the partnership as a limited partner. We held that section 2036 compelled inclusion of this $10 million in the gross estate. We also carefully observed, however, that section 2033 seemed to compel inclusion of the partnership interest in the estate. That's where section 2043(a) does its work--it let us subtract the value of the partnership interest that the estate held.

f. The formula set out by the court is essentially the following:[482]

Value (at death) of partnership interest of decedent that remains in the estate—§ 2033
PLUS
Value (at death) of property transferred by decedent which is included—§ 2036
LESS
Value (at transfer) of partnership interest received by decedent during life—§ 2043(a)
NET INCLUSION AMOUNT IN GROSS ESTATE

g. The courts set outs the following five examples:[483]

Example 1: (Constant Values). During life, decedent contributed land valued at $1,000 to a partnership in exchange for interests worth $500. The transfer is subject to inclusion under sections 2035-2038. There were no changes in value between the contribution date and the date of death. As a result, the net inclusion amount equals $1,000 ($500 + $1,000 - $500).

Example 2: (Inflating Values). Same facts as Example 1, except that the date of death values of the land and the partnership interests have doubled between the contribution date and date of death. As a result, the net inclusion amount equals $2,500 ($1,000 + $2,000 - $500).

Example 3: (Declining Values). Same facts as Example 1, except that the date of death values of the land and the partnership interests have depreciated by 50% between the

[482] $\mathbf{V_{included} = C_d + FMV_d - C_t}$: $\mathbf{V_{included}}$ = value that must be added to the gross estate; $\mathbf{C_d}$ = date-of-death value of the consideration received by the decedent from the transaction that remains in his estate under section 2033; $\mathbf{FMV_d}$ = fair market value at date of death of property transferred by the decedent whose value is included in the gross estate under section 2036; and $\mathbf{C_t}$ = consideration received by the decedent at the time of the transfer, which has to be subtracted under section 2043(a). *Id.* at 16.

[483] *Id.* at 16-17

contribution date and date of death. As a result, the net inclusion amount equals $250 ($250 + $500 - $500).

Example 4: (Discounted Interest, But Simple). Similar facts as Example 1, except that the decedent received a limited partnership interest subject to a 25% discount in exchange for the contribution of land. The value of the partnership interest is $750 after the contribution. There were no changes in value between the contribution date and the date of death. As a result, the net inclusion amount equals $1,000 ($750 + $1,000 - $750).[484]

Example 5: (Discounted Interest, But Not Simple). Same facts as Example 4 except the partnership sells the land for $1,000. The partnership makes a distribution of $400 to the decedent. Assuming the $400 distribution is still in the estate then het net inclusion amount is $1,100 ($400 distribution under § 2033 + $450 for partnership interest under § 2033 [$600 gross value less 25% valuation discount] + $1,000 for the land under § 2036 - $750 value of partnership interest on date of contribution).[485]

h. In summary, the section 2043 analysis results in "double inclusion" if the partnership assets increase in value between contribution and date of death, but a lower value if the assets decrease during that period.

i. The opinion goes on to make some additional modifications. First, the opinion provides that the variable which is the value on date-of-death of the consideration received in the transfer (partnership interest that remains in the estate), is "not limited by tracing rules," meaning that "whatever is left of the original consideration in an estate is included, but so are the proceeds from its later sale because section 2033 includes all property that a decedent owns in his gross estate."[486] Presumably, this states the obvious ($400 has been distributed from the sale of the land, which represents a partial return on the partnership interest). Also, it could refer to the fact that if the decedent had sold the partnership interest to an IDGT in exchange for an installment note, the value of the installment would be included under section 2033 in this calculation of the net inclusion amount. The opinion then goes on to say, "This also means that any property that leaves an estate after a transfer governed by section 2036 but before a decedent's death is *not* generally included in the gross estate."[487] Again, perhaps the opinion is stating the obvious, but if a taxpayer made a gift of the partnership interest received in the contribution, the partnership interests would not be included in the estate under section 2033 and notably, there would be no adjustment to the outside basis of the gifted partnership. This could create a significant and lasting issue for the partners, as discussed below.

C. Section 2036: Inside/Outside Basis Problem

1. As noted above, section 2036 mandates estate tax inclusion of the property held by the partnership. Section 1014(b)(9) provides a basis adjustment to those assets at fair market. If partial consideration is received on the original transfer of property to the partnership, the *Powell* and *Moore*

[484] This seems to be the same as Example 1 except the partnership interest received by the decedent in Example 1 is effectively subject 50% discount (partnership interest on date of transfer was worth $500).

[485] The opinion assumes that the inclusion amount is $1,000 for the contributed land, but the land was sold and $400 of the proceeds were distributed to the decedent. Should the amount included have been $600? What if the land had been sold for a gain of $1,200, would this require $1,200 to be included in the formula?

[486] *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40, at 17.

[487] *Id.*

opinions have ruled that the inclusion amount must be reduced under section 2043(a) by the value of the consideration (partnership interest) received at the time of the original transfer. It's unclear whether the section 2043(a) reduction will reduce the basis adjustment under section 1014(b)(9) or if it is just a nominal reduction that simply reduces the amount of estate inclusion. It appears that the latter is true. Section 1014(a) provides, in pertinent part, "Except as provided in this section, the basis of property in the hands of a person acquiring the property from a decedent shall … be … the fair market value of the property at the date of the decedent's death."[488] There is no provision in section 1014 that provides for a reduction from fair market value. For purposes of the examples below, it is assumed that the basis adjustment to the partnership assets under section 1014(b)(9) will be at fair market value, without any reduction under section 2043(a).

2. The *Powell* and *Moore* opinions make clear that if the consideration (partnership interest) received on the transfer of the property is still held by the decedent on date of death, the partnership interest will also be included in the gross estate under section 2033, and the partnership interest will get a basis adjustment under section 1014(b)(1) of the Code. The resulting outside basis of the partnership interest may or may not equal to the inside basis of the partnership assets. Further, if a section 754 election is in place, section 743(b) may require an inside basis adjustment that could reduce the basis with respect to the transferee of the partnership interest.

> Example: D and D's child, C, create the DC Partnership. D contributes Asset D which has an adjusted basis of $0x and a fair market value of $99x, in exchange for a 99% limited partnership interest. C contributes Asset C which has an adjusted basis of $0x and a fair market value of $1x in exchange for a 1% general partnership interest. At the time of contribution, the 99% limited partnership interest is subject to a 40% valuation discount for a value of $59.4x. Upon D's death, the assets in the DC Partnership have doubled in value to $200x, and D continued to own the 99% limited partnership interest, subject to a 40% valuation discount. Assume section 2036 applies on D's death.
>
> Pursuant to the *Powell* and *Moore* formula, the amount of inclusion is, as follows:
>
> 99% LP interest at 40% discount ($118.8x = 99% * $200x * 60%)—§ 2033
> PLUS
> Partnership assets ($200x)—§2036
> LESS
> 99% LP interest on contribution at 40% discount ($59.4x = 99% * $100x * 60%)—§2043
> NET INCLUSION AMOUNT = $259.4x
>
> The resulting inside and outside basis is as follows:
>
> Inside basis of partnership assets = $200x—§ 1014(b)(9)
> Outside basis of 99% LP interest = $118.8x—§ 1014(b)(1)
> Outside basis of 1% GP interest = $0x
>
> When the inside basis of partnership assets is higher than the outside basis of the partners, then it will eventually result in the loss of basis or capital gain to the partners. If the DC Partnership liquidates and distributes Assets D and C to the partners, the adjusted basis of

[488] § 1014(a)(1). The basis adjustment can, of course, be determined under section 2032, 2032A, and 2031. §§ 1014(a)(2), (3) and (4).

distributed assets will be reduced to $118.8x (the outside basis of the partners).[489] Alternatively, if the DC Partnership sells Assets D and C for $200x and distributes the proceeds to the partners, then the partners will recognize gain of $81.2x ($79.2x gain to the transferee of the 99% LP interest and $2x gain to the 1% general partner).[490]

If in this example DC Partnership has a section 754 election in place, under section 743(b) of the Code, the 99% LP interest transferee's share of inside basis will be reduced by $79.2x (99% * $200x * 40%). Because this inside basis adjustment only applies to the LP transferee, the LP transferee will bear the entire tax burden of this nominal inside basis reduction. For example, if the DC Partnership sells all of the assets of the partnership for $200x, $79.2x of gain will be allocated to the 99% LP transferee.

3. This inside/outside basis discrepancy becomes even more pronounced if the taxpayer transfers the partnership interest during lifetime.

Example: Same facts as the example above except shortly after the contribution of Asset D, D gifts the 99% LP interest to a trust. The amount of net inclusion, of course, is reduced because the 99% LP interest is no longer included in the gross estate:

$0—§ 2033
PLUS
Partnership assets ($200x)—§2036
LESS
99% LP interest on contribution at 40% discount ($59.4x = 99% * $100x * 60%)—§2043
NET INCLUSION AMOUNT = $140.6x

The resulting inside and outside basis is as follows:

Inside basis of partnership assets = $200x—§ 1014(b)(9)
Outside basis of 99% LP interest = $0x—§ 1015
Outside basis of 1% GP interest = $0x

The inside/outside basis discrepancy is even greater now. A liquidation of the partnership will result in a loss of $200x in basis, and a sale of the partnership assets followed by a distribution of the proceeds will result in the recognition of $200x of gain. Under such circumstances, the partners are better off keeping the partnership in existence as long as possible and hoping that the basis discrepancy can be resolved, in whole or in part, by getting an outside basis adjustment at death under section 1014.

4. If, in the example above, D did not gift the LP interest but sold the 99% LP interest to an IDGT in exchange for an installment note, upon D's death the net inclusion amount would be as follows, assuming no valuation discounts to the face value of the installment note (although the inside/outside basis discrepancy would still be the same):

[489] § 732(b).

[490] § 731(a)(1).

$59.4x Installment Note ($59.4x)—§ 2033
PLUS
Partnership assets ($200x)—§2036
LESS
99% LP interest on contribution at 40% discount ($59.4x = 99% * $100x*60%)—§2043
NET INCLUSION AMOUNT = $200x

D. Section 734 Is Not a Solution

1. At first blush, a possible solution to this inside/outside basis conundrum is in section 734(b), which provides:[491]

> In the case of a distribution of property to a partner by a partnership with respect to which the election provided in section 754 is in effect or with respect to which there is a substantial basis reduction, the partnership shall increase the adjusted basis of partnership property shall—
>
> (1) increase the adjusted basis of partnership property by
>
> (A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1), and
>
> (B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution … over the basis of the distributed property to the distributee, as determined under section 732.

2. As noted in the examples above, distributions of money in excess of outside basis causes recognition of gain and distributions of higher basis assets to lower outside basis distributees causes a reduction of basis. This is exactly the situation described in section 734(b). As noted, basis adjustments under 734(b) are made to the common basis of the partnership, so basis adjustments are for the benefit of all of the partners. The unusual fact in this instance, however, is that the adjusted bases of the partnership assets are already equal to their fair market value. Positive basis adjustments are first allocated to assets in the same class with unrealized appreciation in proportion to their relative appreciation. In this instance there is no unrealized appreciation. However, the Treasury Regulations go on to instruct, "Any remaining increase must be allocated among the properties within the class in proportion to their fair market values." So, theoretically, the recognized gain or lost basis can result in inside basis being increased to more than the value of the partnership property. In such case, it might be possible to sell partnership property at a loss, but there may be no outside basis to recognize the loss.[492]

> Example: In the last two examples, upon D's death, the resulting inside and outside basis is:
>
> Inside basis of partnership assets = $200x—§ 1014(b)(9)
> Outside basis of 99% LP interest = $0x—§ 1012
> Outside basis of 1% GP interest = $0x

[491] § 734(b)(1).

[492] § 704(d).

Assume the partnership sells $150x of partnership property and distributes the $150x of proceeds. The sale does not result in any capital gain, but the distribution of $150x results in $150x of gain because the partners have no outside basis. Section 734(b) would allow the partnership to increase the adjusted basis of the remaining partnership property from $50x (what remains after the sale) to $200x. The partnership can sell the property for a loss of $150x. However, none of the partners are able to recognize that loss because they do not have any outside basis. This loss remains suspended until such time as there is outside basis.

3. Alternatively, the partners could contribute low basis assets to the partnership to receive the benefit of the inside basis adjustment. The end result is a basis strip and shift (as discussed above) and the partners are still in the same economic position.

Example: Same situation as above:

Inside basis of partnership assets = $200x—§ 1014(b)(9)
Outside basis of 99% LP interest = $0x—§ 1012
Outside basis of 1% GP interest = $0x

The partners contribute Asset E, in proportion to their percentage interest in the DC Partnership. Asset E has an adjusted basis of zero and fair market value of $200x. After the contribution, DC Partnership has (i) Assets D and C which collectively have and adjusted basis of $200x and fair market value of $200x; and (ii) Asset E (zero adjusted basis and fair market value of $200x). DC Partnership distributes Assets D and C to the partners. As a result, the inside basis of Assets D and C, now in the hands of the partners, is reduced to zero. Assuming DC Partnership has a section 754 election in place, the partnership can increase the basis of Asset E to $200x.

The partners are in the same situation as before, owning partnership interests with no outside basis, and a partnership that has assets with $200x in basis. However, there has been a basis shift. Asset E now has basis when before this transaction it did not, perhaps desirable to the partners for some other reason.

V. "NEGATIVE" BASIS AND "NEGATIVE" CAPITAL

A. What is "Negative" Basis and "Negative" Capital?

1. Debt in Excess of Basis

a. "Negative" basis is the colloquial phrase used to describe a situation where an asset is subject to debt (subject to a mortgage or collateralizing an obligation), and the outstanding debt is greater than the adjusted basis of the asset. This is often referred to "debt in excess of basis," and as discussed earlier, dispositions of these types of assets are taxable events. "Negative" capital is a catch all term that refers to taxpayers who have taken out more (in cash or deductions/losses) than the taxpayer's after-tax investment. This is often made possible by the existence of nonrecourse debt.

b. In the partnership context, "negative" basis appears in the form of nonrecourse partnership liabilities that exceed both the inside bases of the partnership's assets and the outside bases of the partnership interests. "Negative" capital often appears in the form of negative capital account balances. However, the latter is not always true, particularly when capital accounts are "booked-up" for section

704(c) and "reverse" 704(c) purposes. Perhaps a better way to describe "negative" capital is if the partnership sold all of its assets for cash in a taxable transaction, the partners will end up in a deficit, paying all of the cash proceeds and more to lenders and to the government, in the form of taxes.

2. Real Estate Partnerships and Nonrecourse Deductions

a. Introduction

(1) As noted above, an allocation will be deemed to have "substantial economic effect" if "in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden."[493] When partnership property is pledged as security for a nonrecourse loan and the loan goes into default, it is the lender that bears the economic burden if the property does not repay the loan in full. As such, the deductions that are generated by the pledged property (e.g., depreciation or other cost recovery deductions) cannot, by definition, have "substantial economic effect" because those deductions are allocated to the partners who do not bear the economic burden.

(2) As discussed earlier, the U.S. Supreme Court established in *Crane* and *Tufts* that when property is purchased with proceeds of a nonrecourse loan, the purchaser (the partnership) is the sole owner of the property, and as such, the purchaser is the only taxpayer that can claim depreciation with respect to the property. The rulings in *Crane* and *Tufts* also establish that when property subject to a nonrecourse mortgage is disposed of in a taxable transaction, the debt is treated as an amount realized. Despite the fact that the debt is nonrecourse, a sale of the property subject to the debt is treated as if the debt has been discharged. As a result, when property is sold subject to nonrecourse debt that exceeds the adjusted basis of the property, the debtor will recognize gain to the extent of the excess. If the property had been subject to depreciation deductions, this gain offsets those deductions (recaptures the tax benefit of the deductions to the partners). This debt in excess of basis gain is the "minimum gain" that should be recognized by the seller, and this concept is at the heart of how nonrecourse deductions are treated under the Treasury Regulations and how such deductions are recaptured on a subsequent sale of the depreciable property.

b. Treasury Regulation Safe Harbor

(1) Similar to the "substantial economic effect" Treasury Regulations, the nonrecourse deduction regulations adopt a safe harbor approach. At the outset, the Treasury Regulations provide:[494]

> Allocations of losses, deductions, or section 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities ("nonrecourse deductions") cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations. Thus, nonrecourse deductions must be allocated in accordance with the partners' interests in the partnership. Paragraph (e) of this section provides a test that deems allocations of nonrecourse deductions to be in accordance with the partners' interests in the partnership.

(2) The reference to paragraph (e) is where the safe harbor rule is contained. Section 1.704-2(e) provides that allocations of nonrecourse deductions will be "deemed to be in accordance

[493] Treas. Reg. § 1.704-1(b)(2)(ii)(*a*).

[494] Treas. Reg. § 1.704-2(b)(1).

with partners' interests in the partnership only if" the following are satisfied (beginning in the first taxable year in which there are nonrecourse deductions and throughout the full term of the partnership):

(a) The partnership agreement satisfies the conditions of the safe harbor for substantial economic effect (e.g., capital accounts are properly maintained, liquidating distributions are made according to positive capital account balances, and either a qualified income offset or an unconditional deficit restoration obligation);[495]

(b) The partnership agreement provides for allocations of nonrecourse deductions "in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities;"[496]

(c) The partnership agreement must have a "minimum gain chargeback" provision;[497] and

(d) All other material allocations and capital adjustments are recognized under section 1.704-1(b) of the Treasury Regulations.

c. Partnership Minimum Gain

(1) Generally, "partnership minimum gain" is, with respect to "each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of that liability."[498] This is the "debt in excess of basis" mentioned in the context of *Crane* and *Tufts*, discussed above. However, when a property's book value differs from its basis because it was contributed to the partnership at a fair market value different from its basis or because of a "revaluation" under section 704(c) of the Code, discussed later in these materials, the Treasury Regulations use book value, not adjusted basis, in determining partnership minimum gain.[499] The reason for this is that the rules under section 704(c) and "reverse" 704(c), as discussed later in these materials, ensure that any inherent gain in the contributed property at the time of the contribution must be allocated back to the contributing partner, and any inherent gain that exists at the time of a revaluation (including partnership minimum gain) must be allocated to the partners whose book capital accounts were adjusted to reflect changes in book value.

> **Example**: A and B form AB Partnership. A and B each contribute $100x to the partnership in exchange for partnership interests, as equal partners. AB Partnership obtains a nonrecourse loan for $2,800x to purchase a commercial building for $3,000x. Assume that the entire purchase price of $3,000x is depreciable at $100x per year, the loan is interest only until the end of the 10-year term, and for the next 6 years, net rental income exactly offsets interest payments and other expenses. As a result, for 6 years, there is an annual net loss due to depreciation of ($100x). AB Partnership's balance sheet at that time is, as follows:

[495] Treas. Reg. § 1.704-2(e)(1).

[496] Treas. Reg. § 1.704-2(e)(2).

[497] Treas. Reg. § 1.704-2(e)(3).

[498] Treas. Reg. § 1.704-2(d)(1).

[499] Treas. Reg. §§ 1.704-2(d)(3) and 1.704-2(d)(4). *See also* Treas. Reg. § 1.704-2(m), Ex. 3.

AB Partnership Balance Sheet			
Assets		**Liabilities**	
	Book Value	Nonrecourse Loan	$2,800x
Building	$3,000x		
(6 Yrs. Depreciation)	($600x)	**Capital Accounts**	
		Partner A	($200x)
		Partner B	($200x)
Total	$2,400x	Total	$2,400x

In this example, book value of the building is equal to its adjusted basis. There have been no contributions of property with unrealized gain or loss and there have been no other revaluation events. As such, partnership minimum gain is $400x ($2,800x liability less basis of $2,400x) at the end of the 6th year.

(2) Partnership minimum gain is essentially the difference between the nonrecourse loan and the basis of the property collateralizing the loan. As such, additional depreciation (or other cost recovery deductions) will increase partnership minimum gain (assuming the amount outstanding on the loan remains the same or is reduced by an amount less than the depreciation deduction). Partnership minimum gain will also increase if the partnership borrows funds on a nonrecourse basis, using the property as security for the loan.

Example: AB Partnership owns unencumbered property that has a fair market value of $1,000x and an adjusted basis of $400x. AB borrows $700x, securing the loan with the property. As a result of the borrowing, partnership minimum gain increases from zero to $300x.

(3) An increase in partnership minimum gain will generally equal the increase in nonrecourse distributions (defined and discussed later) and nonrecourse deductions (i.e., depreciation) for that year. The aggregate total amount of partnership minimum gain represents the total nonrecourse deductions taken by the partnership and the distributions made by the partnership for which the lender bears the burden of the liability. The Treasury Regulations mandate, through the requirement of a minimum gain chargeback provision, that upon a taxable disposition of the underlying property, the partnership (and its partners) must recognize an offsetting minimum gain.

d. Amount of Nonrecourse Deductions

(1) The amount of nonrecourse deductions is determined annually. The Treasury Regulations provide the "amount of nonrecourse deductions for a partnership taxable year equals the net increase in partnership minimum gain during the year…, reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain."[500] These "distributions of a nonrecourse liability proceeds" are sometimes referred to as "nonrecourse distributions."[501]

Example: AB Partnership owns unencumbered property that has a fair market value of $1,000x and an adjusted basis of $400x. AB borrows $700x, securing the loan with the

[500] Treas. Reg. § 1.704-2(c).

[501] *See* Treas. Reg. § 1.704-2(h).

property. As a result of the borrowing, partnership minimum gain increases from zero to $300x.

If AB Partnership distributes $100x of the proceeds of the loan, the amount of "nonrecourse distributions" that would help determine the amount of allowable nonrecourse deductions is $100x (limited by the amount allocation to an increase in partnership minimum gain). In this case, the net amount of nonrecourse deductions allowable this year would be $200x ($300x increase in partnership minimum gain reduced by $100x of nonrecourse distributions).

If AB Partnership distributes $300x or $700x of the proceeds of the loan, the amount of "nonrecourse distributions" that would help determine the amount of allowable nonrecourse deductions, in either case, will be $300x (limited by the amount allocation to an increase in partnership minimum gain). In either of these cases, the net amount of nonrecourse deductions allowable this year would be zero.

(2) Generally, nonrecourse deductions are comprised of cost recovery deductions on encumbered property. However, there are instances when the cost recovery deductions will be less than the increase in partnership minimum gain. For example, an increase in partnership minimum gain could be attributable to a refinancing against the property, but the proceeds are not distributed (as illustrated above). In such case, the Treasury Regulations contain an ordering rule to determine which of the partnership's deductions will be considered nonrecourse.[502] Importantly, a partnership's nonrecourse deductions for a tax year consist, in first priority, of depreciation or cost recovery deductions with respect to property that is subject to partnership nonrecourse debt.

(3) If partnership property is subject to more than one liability, only the portion of the property's adjusted tax basis that is allocated to a nonrecourse liability is used to compute partnership minimum gain with respect to that liability.[503] If the liabilities are of unequal prior from a creditor standpoint, the adjusted basis is allocated first of the liability of the highest priority, then to the lower priority liabilities in descending order.[504]

e. Minimum Gain Chargeback

(1) A partner's minimum gain chargeback for a taxable year equals the partner's share of the partnership's net *decrease* in minimum gain for that year.[505] Although there are a number of reasons why a partnership's minimum gain would decrease, the most common is the sale of the property subject to the debt.

Example: A and B form AB Partnership. A and B each contribute $100x to the partnership in exchange for partnership interests, as equal partners. AB Partnership obtains a nonrecourse loan for $2,800x to purchase a commercial building for $3,000x. Assume that the entire purchase price of $3,000x is depreciable at $100x per year, the loan is interest only until the end of the 10-year term, and for the next 6 years, net rental income exactly offsets interest payments and other expenses. As a result, for 6 years, there is an annual

[502] Treas. Reg. § 1.704-2(j)(1).

[503] Treas. Reg. § 1.704-2(d)(2)(i).

[504] Treas. Reg. §§ 1.704-2(d)(2)(ii) and 1.704-2(m), Ex. 1(v).

[505] Treas. Reg. § 1.704-2(f)(1).

net loss due to depreciation of ($100x). There have been no contributions of property with unrealized gain or loss and there have been no other revaluation events. As such, partnership minimum gain is $400x ($2,800x liability less basis of $2,400x) at the end of the 6th year.

At the beginning of year 7, AB Partnership sells the property for $3,000x and repays the lender $2,800x (the outstanding principal balance). AB Partnership's adjusted basis in the property, at the time of the sale is $2,400x, so the net recognized gain is $600x. At the end of the 6th year, the total partnership minimum gain was $400x and after the transaction in year 7, partnership minimum gain is zero. Under the minimum gain chargeback provision, the partnership is required to allocate $400x (of the $600x of total recognized gain) to each of the partners in an amount equal to each partner's share of the decrease in partnership minimum gain. In this case, A and B are equal partners, so A and B will each be allocated $200x of gain each under the minimum gain chargeback provision (total decrease of $400x of partnership minimum gain), with the remaining $200x balance of gain also allocated equally also.

(2) The Treasury Regulations provides, "If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain."[506] These minimum gain chargeback allocations are made before any other allocation.[507]

(3) The Treasury Regulations recognize that there are some events that will decrease partnership minimum gain, but it would be inappropriate to allocate income and gain to the partners in such instances. These exceptions to the general rule are:

(a) Certain conversions and refinancings when "the partner's share of the net decrease in partnership minimum gain is caused by a recharacterization of nonrecourse partnership debt as partially or wholly recourse debt or partner nonrecourse debt, and the partner bears the economic risk of loss."[508] In other words, if a partner becomes personally liable for a debt that was nonrecourse (e.g., partner guarantee), the minimum gain chargeback should not apply to such partner because they now hold the economic burden associated with the nonrecourse deductions already taken. The chargeback, however, would still apply to the other partners.

(b) Certain capital contributions when "the partner contributes capital to the partnership that is used to repay the nonrecourse liability or is used to increase the basis of the property subject to the nonrecourse liability, and the partner's share of the net decrease in partnership minimum gain results from the repayment or the increase to the property's basis."[509] In such events, the repayment of the debt and the increase in the basis of the property (through capital improvements to the property) will reduce minimum gain, but because these involve additional investment in the partnership or the property, chargeback should not be applicable.

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[506] Treas. Reg. § 1.704-2(f)(1).

[507] Treas. Reg. § 1.704-2(j)

[508] Treas. Reg. § 1.704-2(f)(2)

[509] Treas. Reg. §§ 1.704-2(f)(3) and 1.704-2(m), Ex. 1(iv).

(c) Certain revaluations of partnership assets (e.g., upon the admission of an additional partner to the partnership) may result in a decrease in partnership minimum gain but, as noted above, when a property's book value differs from its basis because of a "revaluation" under section 704(c) of the Code, discussed in these materials, the Treasury Regulations use book value, not adjusted basis, in determining partnership minimum gain.[510] Under such circumstance, the principles of section 704(c), particularly the "reverse" 704(c) rules,[511] ensure that each partner's share of partnership minimum gain will be allocated appropriately under those rules, eliminating the need to have a minimum gain chargeback in that instance.

(d) Waivers of the minimum gain chargeback requirement, as requested by the partnership, for certain circumstances where the minimum gain chargeback would "cause a distortion in the economic arrangement among the partners and it is not expected that the partnership will have sufficient other income to correct that distortion."[512]

(4) The Treasury Regulations provide that when minimum gain chargeback is required, it will consist "first of a pro rata portion of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and income from the discharge of indebtedness relating to one or more partnership nonrecourse liabilities to which partnership property is subject."[513] Then, if those items are not sufficient, then the chargeback will consist of a pro rata portion of the partnership's other items of income and gain for that year.[514] Any excess minimum gain chargeback remaining after allocating the partnership's income and gains for the taxable year will be carried over.[515]

f. Determining a Partner's Share of Partnership Minimum Gain

(1) A partner's share of partnership minimum gain, as of the end of a tax year, equals:

(a) The sum of all nonrecourse deductions allocated to the partner (and that partner's predecessors in interest), plus the aggregate distributions to the partner (and predecessors) of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain; less[516]

(b) The sum of that partner's (and predecessors) aggregate share of the net decreases in partnership minimum gain, plus the partner's (and predecessors) aggregate share of decreases in partnership minimum gain resulting from revaluations of partnership property encumbered by partnership nonrecourse liabilities.[517]

(2) The foregoing assumes that the partners don't have any obligation to restore any deficit in such partner's capital account on liquidation of the partnership. In other words, the

[510] Treas. Reg. § 1.704-2(d)(4).

[511] Treas. Reg. § 1.704-3(a)(6).

[512] Treas. Reg. § 1.704-2(f)(4).

[513] Treas. Reg. § 1.704-2(f)(6).

[514] *Id. See also,* § 1.704-2(j)(2)

[515] *Id.*

[516] Treas. Reg. § 1.704-2(g)(1)(i).

[517] Treas. Reg. § 1.704-2(g)(1)(ii).

partnership agreement provides for a qualified income offset, as discussed above in the context of the safe harbor for substantial economic effect. If a partner has an obligation to restore any deficit in such partner's capital account, that amount of such restoration obligation is added the partner's share of partnership minimum gain.[518]

g. Distributions of Proceeds from Nonrecourse Liabilities

(1) As noted above, partnership minimum gain attributable to proceeds of nonrecourse debt that are distributed to the partners is allocated to those partners who received the distributions.[519] A distribution of the proceeds of a partnership nonrecourse liability is considered allocable to an increase in partnership minimum gain to the extent of the net increase in partnership minimum gain allocated to such nonrecourse liability.[520] The Treasury Regulations provide that any reasonable method may be used in determining whether a distribution is allocable to the proceeds of a partnership nonrecourse liability.[521]

(2) If a net increase in minimum gain is attributable to more than one nonrecourse liability, the net increase is allocated among the partnership's nonrecourse liabilities in proportion to the amount each liability contributed to the increase in partnership minimum gain.[522] If the net increase in partnership minimum gain allocable to a partnership nonrecourse liability exceeds the distributions allocable to such liability, then that excess amount generally may be carried forward and treated as incurred in succeeding tax years.[523]

B. Illustrative Example

1. The following example will be used to give color to the discussion. It is broken down into four phases:

> **Example (Phase 1-"Buy, Borrow, Build"):** A, B, C, and D are siblings and experienced real estate developers. In 1990, they create ABCD Partnership to buy and develop real estate. To that end, each of the contributes $1 million to the partnership, in exchange for an equal (25%) interest in the partnership. ABCD Partnership purchases undeveloped real estate for $4 million and procures a $36 million nonrecourse loan from a bank to build a multi-family residential rental building, collateralized by the land and the improvements (building). Once the building is constructed, the balance sheet of the partnership could be depicted (this is not a typical balance sheet, as it includes each partner's share of nonrecourse liabilities, along with their outside bases, adjusted to reflect each of their capital contributions and their share of nonrecourse liabilities under section 752(a)), as follows:

[518] Treas. Reg. §§ 1.704-2(g)(2) and 1.704-2(m)(3)(ii), Ex. 3.

[519] Treas. Reg. § 1.704-2(g)(1)(i).

[520] Treas. Reg. § 1.704-2(h)(1).

[521] Treas. Reg. § 1.704-2(h)(2).

[522] Treas. Reg. § 1.704-2(h)(1).

[523] Treas. Reg. § 1.704-2(h)(4).

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**

2. At the end of Phase 1, although the partnership is highly leveraged, neither the assets nor any of the partners' interests reflect "negative basis." The inside basis of the partnership assets that collateralize the nonrecourse debt ($40 million) is in excess of the outstanding loan ($36 million). In addition, each partner's outside basis ($10 million) is in excess of each of their respective share of the partnership liabilities ($9,000,000). If the partners were to make any lifetime or testamentary transfers, there would not by any income tax consequences.

3. Since the building was placed into service after the enactment of the Tax Reform Act of 1986,[524] the building is depreciated using a straight-line method over 27.5 years (approximately, 3.64% of the capital improvements can be deducted each year).[525] However, a cost segregation study can identify items of "personal property"[526] that can be depreciated on an accelerated method, over a cost-recovery period of 5 to 7 years, and for items pertaining to land improvements, over a 15-year period.[527]

> **Example (Phase 2-Depreciate, Depreciate, Depreciate):** Assume that ABCD Partnership conducts a cost segregation study that determines 20% of the total capital improvements are entitled to an accelerated method. Over the next 15 years, it claims the maximum amount of cost recovery deductions, using the deductions to offset as much rental income as possible, paying interest to the bank, and distributing all of net cash flow to the partners.
>
> Over a 15-year period, ABCD Partnership will claim $7.2 million (20% of $36 million of improvements) of accelerated depreciation and 15 years of straight-line depreciation at

[524] The Tax Reform Act of 1986, P.L. 99-514.

[525] Generally, the "applicable recovery period" for residential rental properties used in long-term rental activities are placed in 27.5-year recovery periods, and commercial properties are placed in 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods. § 168(c).

[526] For example, electrical systems, lighting, carpeting, flooring, appliances, cabinets, countertops, signs, fixtures, mirrors, window treatments, audio-visual systems, and communication systems.

[527] For example, parkway and roadway paving, sidewalks and burbs, storm water management systems, irrigation systems, fences and retaining walls, decks, and landscaping components.

$1,046,273 per year (1/27.5 of $28,800,000 of improvements [80% of the $36 million of improvements]) for a total of $15,709,091 of straight-line depreciation. In aggregate ABCD Partnership claims $22,909,091 of depreciation deductions, allocating to each partner $5,727,273 of nonrecourse deductions over the 15-year period, which reduces both the outside basis and capital account of each partner.

After 15 years, in 2005, the balance sheet of the partnership could be depicted, as follows:

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)

4. At the end of Phase 2, notably, both the partnership and the partners have "negative basis" assets. The inside basis of the partnership assets is $17,090.909, collateralizing a debt of $36,000,000. This is reflected in each of the partner's interest in the partnership, each of them having an outside basis of $4,272,727, with a share of partnership liabilities of $9,000,0000. This means that if a partner makes a lifetime gratuitous transfer (gift), gain would be recognized on the disposition under section 752(d). For example, if any of the partners gifted his or her interest, the partner would recognize $4,727,273 of gain ($9 million amount realized less the outside basis of $4,272,727). In addition, the partners have "negative capital," reflected in their capital accounts, which have negative balances. Because deductions reduce both outside basis and capital account, each of the partners now has a negative capital account balance of -$4,727,273. This would be the case despite the fact that the building and the land may have in fact appreciated in value. The depreciation deductions are a tax concept that assumes the improvements to the land, reflected in the capitalized costs, will depreciate in value over time. That is often not reality in real estate development

Example (Phase 3-Revalue and Refinance): By 2020, all of the cost recovery deductions had been taken, and ABCD Partnership continues to allocate and distribute all of the net rental income to the partners equally. ABCD Partnership is contemplating a revaluation of the partnership property, in anticipation of a possible refinancing of the $36 million of nonrecourse debt. Prior to the refinancing, the partnership "balance sheet" is, as follows:

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)

In anticipation of the financing, the partners agree to revalue ("book-up") the partnership assets to their fair market values and adjust the capital accounts of the partners. It is determined that the value land and the building have doubled in value (land is now $8 million and the building is now $72 million in value). As discussed above, the book-up adjustments to capital accounts are determined as if the partnership had sold all of its assets for fair market value, and the resulting gain (or loss, but not in this example) with respect to each asset is allocated to the partners under the terms of the partnership agreement. As a result, the partnership assets and all of the partners' capital accounts are booked-up, as follows:

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 "balance sheet" reflects a book value of $80 million for the partnership assets, and capital accounts are now positive. The hypothetical sale of all of the partnership assets would have resulted in $76 million of gain (sale of $80 million of assets with $4 million of tax basis). Because there were no contributions of property (only cash), that $76 million of gain would be allocated equally to the partners ($19 million each). When added to the negative -$8 million balance capital account balance prior to the book-up, each partner ends up with a positive capital account balance of $11 million. However, even with positive capital account balances, the partnership assets and partnership interests have "negative basis."

ABCD Partnership has $44 million of net equity ($80 million of assets and $36 million of nonrecourse debt). ABCD Partnership negotiates with the bank to refinance the existing $36 million into a $74 million nonrecourse loan. Often, this is treated as a full repayment of the existing loan, and the procurement of a new loan of a larger amount. The net result is an additional net increase in the total nonrecourse liabilities of $38 million. Immediately after the loan is obtained, the "balance sheet" looks, as follows:

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**

5. As noted above, the increase of nonrecourse liabilities, which are shared equally by the partners, is a deemed contribution by the partners under section 752(a). This increases each partner's outside basis (but not capital account) by $9.5 million. The loan and cash increase the inside and outside bases of the partnership and the partners, but "negative basis" remains inside and outside of the partnership.

Example (Phase 4-Distribute Tax Free): Rather than using the loan proceeds to make additional improvements to the building and get future depreciation deductions to offset future income, ABCD Partnership decides to distribute all of the loan proceeds ($38 million) to the partners equally ($9.5 million each). The result for the "balance sheet" of the partnership is, as follows:

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**

6. As illustrated above, after Phase 4, each partner has a partnership interest with an outside basis of $1 million and a capital account of $1.5 million. The partners have reaped the benefits of $36 million of depreciation deductions ($9 million each) and a tax-free distribution of $38 million of cash ($9.5 million each). Partnership taxation has allowed the partners to effectively get $18.5 million of tax-free cash flow, not to mention additional after taxable cash flow from excess rental income that is left after paying the interest on the loan. In addition, through the magic of partnership taxation, the "book-up" has erased the dreaded negative capital account balance, leaving each partner with $1.5 million of net equity in the venture, for an original $1 million cash investment in 1990 and the use of borrowed capital that was nonrecourse, for which none of the partners were personally liable. This was certainly a profitable venture for the partners (the property doubled in value without any additional capital investments), and everything would seem copacetic and rosy. However, as discussed below, this arrangement is a bit of a Faustian bargain, imprisoning the partners to limited planning options in the future where the partner's death (or someone else's death) may be the only viable planning path left.

C. Taxable Sale, No Like-Kind Exchange

1. If ABCD Partnership sells the partnership property in a taxable sale (or exchange), it becomes clear that notwithstanding the positive capital account balance (the existence of net equity in the venture), the Code require the partners to pay a significant toll for having extracted so many tax benefits. A sale of the property for $80 million in cash will produce $76 million in gain. That gain will be allocated to the partners. The character of the gain will be comprised of recapture of the depreciation deductions and long-term capital gain.

2. "Section 1250 property" means any real property, with certain exceptions that are not applicable,[528] that is or has been property of a character subject to the allowance for depreciation.[529] Section 1250(a)(1)(A) provides that if section 1250 property is disposed of, the "applicable percentage" of the lower of the "additional depreciation" in respect of the property or the gain realized with respect to the

[528] § 1245(a)(3).

[529] § 1250(c).

disposition of the property shall be treated as ordinary income. In short, section 1250 provides that all or part of any depreciation deduction in excess of straight-line depreciation is recaptured as ordinary income.[530] The Code does, however, tax "unrecaptured section 1250 gain" at a 25% tax rate. Unrecaptured section 1250 gain is essentially the lesser of all depreciation on the property or the net gain realized (after certain losses) to the extent not treated as ordinary income under section 1250.[531] "Section 1245 property" includes property, which is or has been of a character subject to the allowance for depreciation other than buildings or their structural components.[532] Section 1245(a) provides gain recognized upon the disposition of section 1245 property is ordinary income.[533]

3. Thus, in this example, the gain will be comprised of section 1250 property (taxable at a Federal tax rate of 25%), section 1245 (taxable at ordinary rates of 37%), and long-term capital gain (taxable at a Federal tax rate of 20%, assuming that each of the partners are actively participating in the business). Further, the partners will be liable for state income tax, if the property is located in a state that has an income tax, even if the partners are taxpayers in a state that does not have an income tax. Finally, and perhaps most importantly, the bank must be repaid from the sale proceeds and that repayment does not affect the amount of income tax due on the sale.

4. Based on the example, above, if ABCD Partnership sells the property for $80 million in cash, the after repayment of debt, after-tax results are (assuming a 6% state income tax), as follows:

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)**

As the table illustrates, a taxable sale puts the partners in a significant cash deficit of -$16,496,000, requiring each partner to pay to the Federal and state tax authorities over $4 million out-of-pocket. Keep in mind, each partner had, prior to the sale, $1.5 million of net equity (capital account) in the real estate venture.

5. It is for this reason, many real estate families will often do like-kind exchanges under section 1031 to avoid the payment of this tax, if they desire to dispose of commercial, residential rental, or

[530] § 1250(b)(1), (3), (5).

[531] § 1(h)(6).

[532] § 1245(a)(3).

[533] See § 1245(a).

investment property held by the partnership, but they must acquire other real property investments, and the tax attributes of the sold property follow to the replacement property. The other option is to just hold on to the property for a long period of time, deferring the cost for as long as possible.

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

1. In our example, assume that Partner A decides to hold on to the partnership interest until death. Upon Partner A's death, the partnership interest will be included in his or her gross estate, and as discussed, the partnership interest will get a basis adjustment under section 1014 and as calculated under section 1.742-1 of Treasury Regulations. At the time of A's death, Assume that A's partnership interest is subject to a 33.33% valuation discount, the fair market value for estate tax purpose is $1 million, determined as follows: (i) ABCD Partnership has assets equal to $80 million, less $74 million of nonrecourse debt, for total net equity of $6 million; (ii) A owned 25% "pro rata" interest in the partnership and its assets, for a net equity of $1.5 million (A's capital account balance and the amount that would be paid to A's estate if ABCD partnership was liquidated); and (iii) a 33.33% valuation discount reduced the net equity/liquidation value of the interest by $500,000 (33.33% of $1.5 million) to $1.0 million. At the time of A's death, A's share of partnership liabilities was $18.5 million, which is transferred with the partnership interest to the estate. In addition, ABCD does not have any items of IRD. As a result, the partnership interest has its basis adjusted from $1 million to $19.5 million (FMV of $1.9 million plus estate's share of partnership liabilities of $18.5 million).

2. As noted, absent a section 754 election, the ABCD Partnership "balance" sheet would look, as follows:

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**

3. The immediate effect of the "step-up" in basis to A's partnership interest is that the partnership interest no longer has "negative basis" because the outside basis ($19.5 million) is greater than the estate's share of partnership liabilities ($18.5 million). As a result, any subsequent transfer of the partnership interest by the estate to, for example, a beneficiary or trust will not cause the recognition of gain. However, the outside basis adjustment is not reflected in the assets of the partnership. It is true that the estate could get the benefit of the basis on the assets if the partnership distributed, for example, an undivided 25% interest in the land and the building to the estate in a liquidating transfer under section 732(b). However, that is not a solution in this instance for the following reasons:

a. It is highly likely the lender would not consent to the transfer of a portion of the assets because is collateralized by the debt, and the debt is not being satisfied in conjunction with the transfer.

b. The distribution of the in-kind assets to the estate would increase the basis of those assets by $18.5 million under section 734(a)(1). Thus, it would be considered a "substantial basis reduction" under section 743(d), requiring a mandatory inside basis adjustment under section 734(b)(2). This would require the partnership to decrease the inside bases of the partnership assets by the amount of the basis increase to the distributed property.

c. The distribution of property subject to debt, in liquidation of a partner, can reduce the share of partnership liabilities of the remaining partners, which in turn can be a deemed distribution of money under 752(b).

d. The transfer of real property interests is often subject to certain transfer taxes and can cause a reassessment of value for property tax purposes.

4. For all of the foregoing reasons, making a section 743 election is advisable in these circumstances. Assuming ABCD Partnership makes a section 754 election, under section 743(b)(1), the inside basis of the partnership assets will be increased by the excess of the estate's outside basis in the partnership interest ($19.5 million) over the estate's proportionate share of the inside bases of the partnership property. The proportionate share of the inside basis, in turn, is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities ($18,500,000).[534] A partner's previously taxed capital is the amount The amount of cash the partner would receive upon a liquidation of the partnership following a hypothetical sale of all of the partnership assets (immediately after death) in a fully taxable transaction for cash equal to the fair market value of the assets,[535] decreased by (in this case because there is no property at a loss), the amount of tax gain that would be allocated to the partner in the hypothetical transaction. [536]

5. In a hypothetical liquidation of ABCD Partnership would distribute $1.5 million in cash to A's estate (its capital account balance). In the hypothetical sale, the estate would be allocated $19 million of gain. As a result, the partner's previously taxed capital is negative -S17.5 million. The partner's proportionate share of the inside basis is $1 million (-$17.5 million plus $18.5 million). The result is, the inside basis of the partnership assets will be increased by the difference between the outside basis ($19.5 million) and the estate's proportionate share of inside basis ($1.0 million), resulting in a positive inside basis adjustment of $18.5 million under section 743(b)(1).

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[534] Treas. Reg. § 1.743-1(d)(1).

[535] Treas. Reg. § 1.743-1(d)(2).

[536] Treas. Reg. § 1.743-1(d)(1).

6. As explained in more detail above, section 755 provides that the inside basis adjustment is divided among two classes of partnership assets, ordinary income property and capital gain property. Capital gain property includes capital assets and section 1231(b) property. All other property is considered ordinary income property. In particular, and applicable to this example, "properties and potential gain treated as unrealized receivables under section 751c) and the regulations thereunder shall be treated as separate assets that are ordinary income property."[537] Originally, the definition of "unrealized receivables" under section 751(c) only included rights to payments for services and rights to payments for goods. Since its enactment, 751(c) property has been expanded to include many additional types of property, the sale of which would result in the realization of ordinary income.[538] Today, under the Treasury Regulations, "unrealized receivables" includes section 1245 property, but only to the extent that ordinary income would be recognized under section 1245(a) if a partnership were to sell the property at its fair market value.[539] The amount is treated as an unrealized receivable with a zero basis. In this example, the section 1245 recapture amount of $7.2 million will be treated as an ordinary income asset with a zero basis. The remainder of the depreciable asset (building) is section 1250 property and considered capital gain property.

7. The amount allocated to each class of assets (ordinary or capital), the Treasury Regulations employ a hypothetical transaction where the partnership makes a cash sale of all of the partnership assets for fair market value and the transferee's share of the gain or loss from each asset must be calculated.[540] The portion of the basis adjustment allocated to ordinary income property is equal to the total income, gain, and loss that would be allocated to the transferee with respect to the sale of ordinary income property in the hypothetical transaction.[541] The basis adjustment to capital gain property is equal to the total section 743(b) basis adjustment reduced by the amount allocated to ordinary income property.[542] In this example, of the $18.5 million of available inside basis adjustment is first $7.2 million is allocated to the ordinary income property, the section 1245 property (unrealized receivable with zero basis). The remaining $11.3 million adjust the basis of the capital gain property, namely the building and the land. If the building and the land are held as legally distinct assets from each other, within the capital gain class, the remaining $11.3 of inside basis adjustment would need to be allocated between the two based upon the unrealized appreciation each asset and each asset's relative fair market value.[543] As discussed above, there is an inside basis "short fall" created by the valuation discount ($500,000), so each asset within this class cannot get a full "step-up" in basis.[544]

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[537] Treas. Reg. § 1.755-1(a)(1).

[538] One court ruled that section 751(c) "invites a liberal construction by stating that the phrase 'unrealized receivables' *includes* certain specified rights, thereby implying that the statutory definition of term is not necessarily self-limiting." *Logan v. Commissioner*, 51 T.C. 482, 486 (1968).

[539] § 704(c) and Treas. Reg. §§ 1.751-1(c)(4)(iii), -1(c)(5).

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

[541] Treas. Reg. § 1.755-1(b)(2)(i).

[542] *Id.*

[543] *See* § 1.755-1(b)(3)(ii).

[544] The allocation of the shortfall to the land ($1 mil. of gain on the hypothetical gain minus the product of ($12.8 mil. of gain in the capital gain class minus $11.3 of total adjustments to the capital gain class) multiplied by the following fraction ($2 mil. fair market value of the land divided by $13.8 mil. fair market value of all capital gain assets in the class). The allocation of the shortfall to the section 1250 gain on the building ($11.8 mil. of gain on the hypothetical gain minus the product of ($12.8 mil. of gain in the capital gain class minus $11.3 of total adjustments to the capital gain class) multiplied by the following fraction ($11.8 mil. fair market value of the section 1250 gain on the building divided by $13.8 mil. fair market value of all capital gain assets in the class).

8. The inside basis adjustment under section 743(b) will be reflected on the balance sheet as follows:

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**

9. As discussed, these inside basis adjustment are notional, and only apply to A's estate and subsequent successors to the interest. Importantly, the section 743(b) adjustment provides almost eliminates the estate's share of partnership minimum gain of the estate and it also provides the estate (and its successors in interest, the beneficiaries of the estate) with approximately $17.7 million of depreciable basis and the deductions that follow with that basis increase. Of course, all of these benefits come at the cost of estate tax inclusion and possibly the payment of estate taxes. However, the amount includible in this example, is $1 million, assuming no state estate or inheritance tax, then the maximum estate tax cost is $400,000. There would be no estate tax cost if A had sufficient base exclusion amount on the date of death.

E. Partner B: Gift of the Partnership Interest

1. In this example, assume that Partner B, during his or her lifetime, gifts the partnership interest to a non-grantor trust. At the time of the gift, Partner B's outside basis is $1 million, capital account is $1.5 million, but B's share of liabilities is $18.5 million. As noted, under section 752(d), the IRS's position is that this disposition discharges of B's liabilities, as such, it is treated as part gift, part sale transfer. As such, B is treated as receiving an amount realized of $18.5 million, and B recognizes $17.5 million of gain.

2. If a partner sells his or her partnership interest in a taxable transaction, the transferor recognizes gain or loss in accordance with the rules of section 1001.[545] The transferee takes a cost basis in the acquired partnership interest,[546] but the transferee's capital account is not based on the consideration tendered. The capital account of the transferee carries over from the transferor partner.[547] The purchased partnership interest carries with it the transferor's share of section 704(c) gain (both forward and reverse) in the partnership's assets.[548] The character of the gain recognized by the selling partner is capital subject to recharacterization under section 751(a) for "hot" (ordinary) assets under section 751(a).[549] Capital gain or loss is recognized as it would be under section 1001 less the amount of ordinary income (or plus the amount of ordinary loss) recharacterized under section 751(a).[550]

3. Section 1(h) provides that the tax rate on the capital gain portion of the sale is determined by looking through to the partnership assets at the time of the sale.[551] As a result, the transferor partner may recognize capital gain at a 20%, 25%, and 28% rate (along with the 3.8% net investment income tax, if applicable to the taxpayer) depending on the nature of the assets in the partnership. The capital gain will be short-term or long-term depending on the transferor partner's holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, as discussed above, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest.[552] As a result, the sale of a partnership interest can result in ordinary income, short-term capital gain, and long-term capital gain at a multitude of different rates.

4. In this example, looking to the assets of the partnership, a sale of all of the assets for $80 million of cash would produce a total of $76 million of gain, comprised of, the following: (i) $7.2 million of section 1245 (ordinary) recapture gain (9.47% of the total); (ii) $28.8 million of section 1250 recapture gain (37.89% of the total); and (iii) $40 million of long-term capital gain (52.63% of the total). In allocating the $17.5 million of recognized gain, a pro rata portion will be taxed to B, as the following table illustrates:

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)

[545] § 741.

[546] § 742.

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

[548] Treas. Reg. § 1.704-3(a)(7).

[549] § 741.

[550] Treas. Reg. § 1.751-1(a)(2).

[551] § 1(h)(5)(B), (h)(9), (h)(10) and Treas. Reg. § 1.1(h)-1(a).

[552] Treas. Reg. § 1.1223-3.

State Income Tax (6%)	$17,500,000	($1,050,000)
	TOTAL	**($5,163,421)**

5. B will have to pay over $5.1 million in income tax as a result of the gift. In addition, B might also have to pay gift taxes on the transfer, of $400,000 assuming a 33.33% valuation discount on the transfer ($1.5 million capital account), if B does not have any available base exclusion amount available at the time of the transfer.

6. As a result of the part gift, part sale transfer, the donee will have an outside basis of $18.5 million, and if gift tax is payable, the outside basis will be increased by the gift tax and increased $400,0000. Assuming that ABCD Partnership has a section 754 election in place, and no gift tax is payable, the "balance sheet" of the partnership will be, as possible:

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	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**

7. By way of explanation, under section 743(b)(1), the inside basis of the partnership assets will be increased by the excess of donee's outside basis in the partnership interest ($18.5 million) over the estate's proportionate share of the inside bases of the partnership property. The proportionate share of the inside basis, in turn, is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities ($18,500,000). As in the Option 1 above, in the hypothetical sale and liquidation, B's proportionate share of the inside basis is determined to be $1 million. The result is, the inside basis of the partnership assets will be increased by the difference between the outside basis ($18.5 million) and the estate's proportionate share of inside basis ($1.0 million), resulting in a positive inside basis adjustment of $17.5 million under section 743(b)(1). In the same manner as the valuation discount in Option 1 above

created a "shortfall," the amount realized is less than the "full" amount of inside basis adjustment ($19 million of inside basis adjustments).[553]

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

1. In this example, assume that Partner C, during his or her lifetime, gifts the partnership interest to an IDGT. Under Revenue Ruling 85-13, the transfer will be disregarded for all Federal income tax purposes. Upon the subsequent death of the grantor, the IDGT will be converted to a taxable non-grantor trust. As noted in Revenue Ruling 2023-2, after the death of the grantor, the adjusted basis of the assets that were held in an IDGT will be the same as they were prior to the grantor's death. The assets are not entitled to a basis adjustment under section 1014. As a result, it seems in this example, the Partner C's death will be a considered a part gift, part sale as in the Option 2 with Partner B.

2. As a result, based on these facts, upon the death of Partner C, C's estate will recognize $17.5 million of gain and will be liable for over $5.1 million in income taxes. Under section 743(b), the donee will get the benefit of $17.5 million in basis adjustments. Notably, the donee will get the benefit of almost $16.9 million of tax basis that can be depreciated over time (and a near but not complete elimination of partnership minimum gain).

G. Partner D: Gift to an IDGT, Death of a Beneficiary with a Power of Appointment

1. In this example, assume that Partner D, during his or her lifetime, gifts the partnership interest to an IDGT. The class of beneficiaries of the IDGT includes D's parent. The terms of the IDGT grant D's parent a testamentary general power of appointment over the partnership interest. While Partner D, the grantor, is still alive, D's parent dies. Assume, in this instance, D's parent exercises the power of appointment, in favor of a trust for the benefit the parent's descendants[554] ("Trust 2"). As a result, the partnership interest is included in the gross estate of the parent.

2. A general power of appointment, as defined in the Code,[555] is a power exercisable in favor of: (i) the power holder, (ii) his or her estate, (iii) his or her creditors, or (iv) creditors of his or her estate. From a transfer tax standpoint, the mere existence of an exercisable general power of appointment at the death (a testamentary general power) of the power holder will cause assets subject to the power to be includible in the power holder's estate.[556] Moreover, the lack of knowledge of the existence of a general power of appointment will not exclude the property subject to the power form being included in the estate of the deceased power holder.[557]

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[553] The allocation of the shortfall to the land ($1 mil. of gain on the hypothetical gain minus the product of ($12.8 mil. of gain in the capital gain class minus $11.3 of total adjustments to the capital gain class) multiplied by the following fraction ($2 mil. fair market value of the land divided by $13.8 mil. fair market value of all capital gain assets in the class). The allocation of the shortfall to the section 1250 gain on the building ($11.8 mil. of gain on the hypothetical gain minus the product of ($12.8 mil. of gain in the capital gain class minus $11.3 of total adjustments to the capital gain class) multiplied by the following fraction ($11.8 mil. fair market value of the section 1250 gain on the building divided by $13.8 mil. fair market value of all capital gain assets in the class).

[554] If Partner D is a beneficiary of Trust 2, the assets of Trust 2 may be included in Partner's D's estate under section 2036, unless the governing law of the trust provides that D's creditors may not attach the assets in Trust 2, despite the fact that D was the original grantor of the assets.

[555] §§ 2041(b)(1) and 2514(c).

[556] § 2041(a)(2) and Treas. Reg. § 20.2041-3(b).

[557] *Freeman Estate v. Commissioner*, 67 T.C. 202 (1976).

3. From an income tax standpoint, if the holder of the power exercises a testamentary general power, the property passing under the power is deemed to have passed from the deceased power holder without full and adequate consideration, and the property will get a "step-up" in basis.[558] If the holder of the power dies without exercising the testamentary general power of appointment, the property that was subject to the power is also deemed to have been acquired from the deceased power holder and such property will receive a "step-up" in basis.[559]

4. Section 1014(b)(4) of the Code provides, "Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will"[560] is considered "to have been acquired from or to have passed from the decedent." Assets passing pursuant to the exercise of a testamentary general power of appointment would also be includible in the power holder's estate under section 2041 of the Code, whether or not exercised, under section 2041 of the Code and entitled to a basis adjustment under section 1014(b)(9).

5. The Treasury Regulations provide: [561]

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

6. The Treasury Regulations also include the following example:[562]

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

7. Thus, Trust 2 arises because the parent exercised the general power of appointment, and the parent is the grantor for income tax purposes, and Trust 2 will be a non-grantor trust for income tax purposes. Assuming this is the case, it means that the result in his instance should be the same as Option 1 above when Partner A died owning the partnership interest. Assuming ABCD Partnership has a section 754 election, the section 743(b) inside basis adjustments for the benefit of Trust 2. As discussed, these inside basis adjustments are notional, and provides Trust 2 (and the beneficiaries of Trust 2) with approximately $17.7 million of depreciable basis and the deductions that follow with that basis increase. Of course, all of these benefits come at the cost of estate tax inclusion and possibly the payment of estate taxes. However, the amount includible in this example, is $1 million, assuming no state estate or

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[558] Treas. Reg. § 1.1014-2(a)(4).

[559] Treas. Reg. § 1.1014-2(b)(2).

[560] § 1014(b)(4). *See also,* Treas. Reg. § 1.1014-2(a)(4).

[561] Treas. Reg. § 1.671-2(e)(5).

[562] Treas. Reg. § 1.671-2(e)(6), Ex. 9.

inheritance tax, then the maximum estate tax cost is $400,000. There would be no estate tax cost if D's deceased parent had sufficient base exclusion amount on the date of death.

ABCD Partnership (with Section 754 Election) "Balance Sheet" *Exercise of a General Power of Appointment*					
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	$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**

8. What then happens if D's parent dies without exercising the general power of appointment? Rather, D's parent allows the power to lapse, and the partnership interest stays in the IDGT. As noted above, there will be estate tax inclusion in the parent's estate (valued at $1.0 million, assuming a 33.33% valuation discount). However, notwithstanding inclusion in the parent's estate, it seems that the IDGT remains a grantor trust as to D. In other words, prior to the parent's death, D was considered the partner under Revenue Ruling 85-13, and after the parent's death, D remains the partner for Federal income tax purposes. What this effectively means is there is no successor in interest to the partnership interest, and there is no successor in interest that receives a share of the partnership liabilities. There is simply no transfer at all.

9. As discussed above, the Treasury Regulations provide, "The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death …, increased by his estate's or other successor's share of partnership liabilities, if any, on that date…"[563] It is unclear whether one can argue that D, as grantor of the IDGT, acquired the partnership interest from the decedent (D's deceased parent). More importantly, D does not acquire any additional share of partnership liabilities as a result of the death of D's parent. So, unusually, it would seem that the lapse of the general power of appointment does not provide the same adjustment to basis that the exercise of the same power would. In this instance, it would seem that, at most, D would "acquire" the interest with a basis adjustment under section 1014 equal to the fair market value of the partnership interest ($1.0 million, assuming a 33.33% valuation discount) but with no additional adjustment for partnership liabilities. Clearly, section 1.742-1 of the Treasury Regulations was not written with this (general power of appointment) scenario in mind, and only works cleanly when a partner dies owning the partnership interest. Thus, in this example, there

[563] Treas. Reg. § 1.742-1.

is no additional adjustment to the partnership interest and there is no inside basis adjustment, even with a section 754 election in place. This is because the outside basis of the partnership interest was $1.0 million at the time of the parent's death, which is exactly equal to the partner's proportionate share of the inside basis of the partnership property.

ABCD Partnership (with Section 754 Election) "Balance Sheet" *Lapse of a General Power of Appointment*					
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**

H. 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.)

Notwithstanding the foregoing discussion, in the case of an exercise of a testamentary general power of appointment, the IRS could argue that there is a deemed transfer from the grantor of the IDGT to the power holder (D's parent) immediately prior to the death of D's parent and prior to the inclusion in the decedent's estate. This would, as with the case of a gift or conversion to a non-grantor trust due to the death of the grantor, cause gain recognition as a part gift, part sale.

VI. DEATH CAUSING A CONVERSION OF A DISREGARDED ENTITY

A. Generally

1. A "disregarded entity" has come to mean an entity that is ignored for Federal income tax purposes, but is legally recognized for other purposes as a separate entity for state law purposes.[564] As the Treasury Regulations provide, "if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."[565] Effectively, the entity is "disregarded as an entity separate from its owner if it has a single owner,"[566] and this applies for "federal tax purposes."[567] Generally, there are three types of entities that are considered "disregarded" for tax purposes: (a) single-owner entities (like wholly-owned LLCs) that have not elected corporate treatment, (b) qualified subchapter S corporation subsidiaries, and (b) qualified real estate investment trust subsidiaries. For purposes of these materials, only LLCs are discussed.

2. Despite the single owner requirement, the IRS has ruled that if an entity is wholly owned by two spouses as community property, it will nevertheless be considered a disregarded entity, provided the spouses report the entity as such.[568] The ruling does not require that the parties file a joint return. It further provides that a change in reporting position (presumably by either spouse) will be treated as a conversion of the entity (e.g., to a partnership). The ruling provides that the business entity must be "wholly owned" by the spouses as community property and "no person other than one or both spouses would be considered an owner for federal tax purposes."[569]

3. Further, the IRS has ruled that a state law partnership formed between an entity disregarded under the elective classification regime (wholly owned LLC of a corporation) and its owner (the corporation) is itself disregarded because it only has one owner for tax purposes.[570]

B. Conversion of Disregarded Entity to Partnership

1. Given that grantor trust status must necessarily terminate with the death of the grantor, all disregarded entities owned by a grantor and one or more grantor trusts will be converted to another type of entity upon the death of the grantor (unless, in theory, the grantor's interest is transferred to the trust and the trust is the only other member of the LLC). It is important then to understand the tax consequences of the conversion of the disregarded entity to (most likely) a partnership.

2. In Revenue Ruling 99-5,[571] the IRS provided guidance on the tax issues involved in a conversion of a disregarded entity to a partnership. The ruling addresses 2 situations with respect to a wholly-owned LLC that is disregarded for tax purposes and that is initially owned by a single member A.

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[564] Generally, a business entity that is not classified as a corporation (eligible entity), that has a single owner, and that has not elected to be taxed as an association taxed as a corporation. *See* Treas. Reg. § 301.7701-3(a) and -3(b)(1)(ii).

[565] Treas. Reg. § 301.7701-2(a).

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

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

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

[569] *Id.*

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

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

The ruling assumes that the LLC has no liabilities, the assets are not subject to any indebtedness, and all of the assets are capital assets or property described in section 1231 of the Code.

a. In situation 1, B purchases 50% of A's ownership in the LLC for $5,000. The ruling concludes that the LLC is converted to a partnership when B purchases the interest in the LLC from A. The purchase of the LLC interest is treated for tax purposes as if B purchased 50% of each of the LLC's assets (which are, in turn, treated as if held by A for tax purposes). Immediately thereafter, A and B are deemed to contribute their respective interests in those assets to a newly formed partnership. Under such treatment, the ruling further provides:

(1) Member A recognizes gain or loss on the deemed sale under section 1001 of the Code. However, there is no further gain or loss under section 721(a) of the Code for the contribution of asset to the partnership in exchange for partnership interests in the newly formed entity.

(2) Under section 722 of the Code, B's outside basis in the partnership is $5,000, and A's outside basis is equal to A's basis in A's 50% share of the assets in the LLC. Under section 723 of the Code, the partnership's tax basis in the assets is the adjusted basis of the property in A and B's hands immediately after the deemed sale.

(3) Under section 1223(1) of the Code, A's holding period for the partnership interest includes his or her holding period in the assets held by the LLC, and B's holding period for the partnership interests begins on the day following the date of B's purchase of the LLC interest from A.[572] Under section 1223(2) of the Code, the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

b. In situation 2, B contributes $10,000 to the LLC for a 50% ownership interest in the LLC. In this instance, as in the previous situation, the ruling concludes that the LLC is converted to a partnership when B contributes the cash to the LLC in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to a newly formed partnership. Under such treatment and facts, the ruling provides:

(1) There is no gain or loss to A or B under section 721(a) of the Code.

(2) Under section 722 of the Code, B's outside basis is equal to $10,000, and A's outside basis is his or her basis in the assets of the LLC which A is treated as contributing to the new partnership. Under section 723 of the Code, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.

(3) Under section 1223(1) of the Code, A's holding period for the partnership interest includes A's holding period in the LLC assets deemed contributed when the disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section 1223(2), the partnership's holding period for the assets transferred to it includes A's holding period.

3. Unfortunately, the foregoing ruling does not address (i) nontaxable transactions like sales or exchanges of a disregarded entity interests between a grantor and his or her grantor trust (situation 1 is a taxable sale) or (ii) contributions of assets to a disregarded entity by a grantor or grantor trust. Under

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

those circumstances, how should the tax basis be allocated among the grantor and the grantor trust? It seems that given the IRS's position in Revenue Ruling 85-13 that grantor trusts are "ignored" or also disregarded, that the unitary basis rules would apply in such a way that if B was a grantor trust in the situations described in Revenue Ruling 99-5, B's outside bases would not be $5,000/$10,000 respectively. Rather, the aggregate basis of A (the grantor) and B (the grantor trust) would be allocated pursuant to the unitary basis rules, as discussed in more detail above (essentially B would receive a portion of A's basis in the transferred asset). Further, the ruling does not address the conversion of a disregarded entity to a partnership when grantor trust status is lost and the trust holds only a portion of the entities interest. Again, it seems that an allocation of the unitary basis is warranted, as discussed above.

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

1. As mentioned above, the conversion from grantor to non-grantor trust (e.g., upon death of the grantor) is treated as a transfer by the grantor of the underlying property in the trust. Often, the original transfer of the property is pursuant to an installment sale to an IDGT, with the purchase effectuated by a promissory note from the IDGT to the grantor and the IDGT's debt obligations collateralized by the transferred property. If the promissory note is outstanding at the time of conversion from grantor to non-grantor trust, gain will be recognized to the extent that the debt encumbering the property is in excess of its tax basis.[573]

2. Grantors and their IDGTs may be able to use disregarded entities to eliminate the potential gain and provide for a step-up in basis on the underlying assets upon the death of the grantor. To illustrate how this might be accomplished, consider an IDGT that holds an asset worth $100x and an adjusted basis of $0x, but the asset is encumbered by a $50x liability of the IDGT to the grantor, as evidenced by an installment note (e.g., paying interest annually and with an outstanding principal amount of $50x) held by the grantor. If the grantor dies, (i) the promissory note would be includable in the grantor's estate and get a "step-up" in basis, (ii) the asset in the IDGT would be out of the grantor's estate but would not get a "step-up" in basis, and (iii) $50x of gain would have to be recognized by the estate because of the liability in excess of tax basis.

3. To avoid this result, the grantor and the IDGT could simultaneously contribute their respective interests in the property and the debt to a newly formed LLC. IDGT would contribute the asset, along with its $50x liability to grantor, to the LLC. Grantor would contribute the installment note with a principal amount of $50x. Assuming, the net value of the asset and the promissory note were both equal to $50x, IDGT and grantor would be equal (each 50% owners) members in the LLC, but the LLC would continue to be a disregarded entity because they are considered the same taxpayer. As such, the contribution of the asset (subject to the debt) and the promissory note should not have any tax ramifications.

4. The LLC, as a separate legal entity, now owns an asset with a gross value of $100x, has a debt liability of $50x, and it owns the right to receive the $50x debt. In other words, if a person has a debt but also owns the right to be paid on the debt, the debt should by law be extinguished. Further, because the LLC is disregarded and the members of the LLC are the same taxpayer due to the grantor trust rules, the extinguishment of the debt should have no tax ramifications. This leaves the LLC simply holding an asset worth $100x (and no liabilities) with the IDGT and grantor each owning 50% of the LLC.

5. Upon the death of the grantor, there is a deemed transfer of 50% of the LLC to the trust (no longer a grantor trust) which converts the disregarded entity to a partnership for tax purposes under

[573] *See, e.g., Crane v. Commissioner*, 331 U.S. 1 (1947). *See also* Treas. Reg. §§ 1.1001-2(a)(4)(v), 1.1001-2(c), *Ex. 5*, and Rev. Rul. 77-402, 1977-2 C.B. 222, in the partnership context.

situation 1 of Revenue Ruling 99-5. As discussed above, such a conversion is treated as an acquisition of the LLC assets by the members and a contribution of those assets to a new partnership. Significantly, if the conversion is treated this way, then for step-up in basis purposes, the estate does not own a 50% interest in a partnership, rather the estate is deemed to own 50% of the assets which are simultaneously contributed to a partnership at death. As such, the estate should be entitled to claim a step-up in basis under section 1014(a) of the Code for 50% of the value of the asset in the LLC without risk of losing basis due to valuation discounts.

6. Under sections 722 and 723 of the Code, the estate should have an outside basis in the LLC of $50x, and the LLC should have an inside basis of $50x on the asset which is worth $100x. Practitioners taking this position will likely want to report the inclusion of 50% of LLC assets in the estate of the grantor, rather than a 50% interest in the LLC, and out of an abundance of caution, ensure that the LLC makes a section 754 election, entitling it to an inside basis adjustment under section 743(b), in case there is a question as to whether the LLC has $50x of inside basis on the asset.

VII. INCOME TAX ISSUES IN THE YEAR-OF-DEATH

1. Section 706(c)(1) provides, except "in the case of a termination of a partnership," the partnership's taxable year will not close due to the "death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership."[574] However, the partnership will close with respect to a partner (and only such partner) whose "entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise)."[575] As a result, the decedent's share of year-of-death income or loss will be apportioned between the decedent and his estate or other successor to the decedent's interest under section 706(d).

2. In the family-owned partnership context, almost all partnerships are on the calendar year, so closing of the taxable year with respect to a decedent partner cannot cause more than twelve months of partnership income or loss to be disproportionately allocated on the decedent's final income tax return.[576]

3. As discussed above, when a decedent passes away owning an asset (like a partnership interest) that has an adjusted (outside) basis greater than its fair market value, it will result in a "step-down" in tax basis to fair market value under section 1014. This could be due to valuation discounts or due to partnership assets with inside bases that are greater than their fair market value. In addition, if the partnership owns a significant amount of assets with unrealized losses, the death of the partner could cause the partnership to make mandatory inside basis adjustments under section 743(b) because the partnership is deemed to have a "substantial built-in loss."[577] For that reason, the common advice provides that prior to death, taxpayers should recognize any unrealized losses. These losses can offset any gains that the taxpayers will recognize, even if that is on a decedent's last income tax return.

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[574] § 706(c)(1).

[575] § 706(c)(2)(A).

[576] Prior to enactment of the Taxpayer Relief Act of 1997, the partnership year of a partner who died prior to 1998 did not close automatically, no apportionment was required, and the decedent's entire share of partnership income or loss for the year of death was taxed to the decedent's estate or successor. This eliminated any possible bunching. While bunching is possible under current law, it is rare because of the prevalence of the calendar tax year for individuals and partnerships. See § 706(b)(1)

[577] § 743(d)(1).

4. Unfortunately, individual taxpayers, estates, and trusts may not carryback capital losses to offset gains in previous taxable years.[578] Further, the IRS has held that capital losses (and carryovers of the same) are only deductible by the taxpayer who sustained the loss.[579] If spouses sell securities or other capital assets held jointly at a loss in the year of death of one of the spouses, then half of the loss can be allocated to the surviving spouse and can be carried forward.[580] If the loss is attributable only to the decedent spouse, any capital loss carryforwards, not otherwise offset by gains on the last return, are lost. As such, taxpayers should be vigilant to recognize losses as soon as possible and offset those losses by recognizing gain on assets that are owned by the taxpayer and the taxpayer's IDGTs.

VIII. CONCLUSION

The basis adjustment at death under section 1014 can erase many ills for taxpayers. When assets are owned directly by the decedent, the basis adjustment is straightforward. However, when the decedent is a partner in a partnership, and those assets are owned by a partnership, the application of the basis adjustment is much more complex. These materials are an attempt to bring light to these complexities.

[578] *See* § 1212.

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

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