RETAINING, OBTAINING, AND SUSTAINING BASIS

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I. INTRODUCTION[***]

A. The Old Paradigm: When In Doubt, Transfer Out

The year 2013 marked the beginning of a significant change in perspective for estate planners with the enactment of the American Taxpayer Relief Act of 2012 (ATRA) and the imposition of the 3.8% Medicare contribution tax on unearned passive income (3.8% Medicare tax), enacted as part of the Health Care and Education Reconciliation Act of 2010 (HCERA) which amended the Patient Protection and Affordable Care Act (PPACA).[1]

For many years, estate planning entailed aggressively transferring assets out of the estates of high net worth individuals during their lifetimes to avoid the imposition of estate taxes at their deaths—giving up a "step-up" in basis adjustment under section 1014 of the amended Internal Revenue Code of 1986 (the Code).[2] Because the estate tax rates were significantly greater than the income tax rates, the avoidance of estate taxes (typically to the exclusion of any

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1. *See* American Taxpayer Relief Act, Pub. L. No. 112-240, 126 Stat. 2313 (2013); I.R.C. § 1411 (2012); Heath Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010); Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010).

2. *See Income and Estate Taxes: The Need for a Holistic Approach to a Chronic Condition*, MURTHA CULLINA, http://www.murthalaw.com/files/holistic_approach_income_and_estate_taxes_10_2014.pdf (last visited Oct. 15, 2014).

potential income tax savings from the step-up in basis) was the primary focus of tax-based estate planning for wealthy individuals.[3]

For example, consider the planning landscape in 2001. The federal estate and gift tax exemption equivalent was $675,000.[4] The maximum federal transfer tax (collectively, the estate, gift, and generation-skipping transfer tax) rate was 55%, and the law still provided for a state estate tax federal credit.[5] Because virtually all of the states had an estate or inheritance tax equal to the credit, the maximum combined federal and state transfer tax rate was 55%.[6] The combined federal and state income tax rates were significantly lower than that.[7] Consider the maximum long-term capital gain and ordinary income tax rates of a highly taxed individual, a New York City taxpayer. At that time, the combined maximum federal, state, and local income tax rate for long-term capital gains was approximately 30% and for ordinary income it was less than 50%.[8] As a result, the gap between the maximum transfer tax rate and the long-term capital gain tax rate for a New York City taxpayer was approximately 25%. For high income, high net worth individuals in New York City, there was a 25% tax rate savings by avoiding the transfer tax and foregoing a step-up in basis.[9] Because this gap was so large (and larger in other states), estate planning recommendations often came down to the following steps, ideas, and truths:

(a) Typically, as the first step in the estate planning process, the taxpayer would make an *inter vivos* taxable gift using the $675,000 exemption equivalent, thereby removing all future appreciation out of the estate tax base.[10]

(b) The taxpayer would use the exemption equivalent gift as a foundation to transfer additional assets out of the estate during lifetime.[11] For example, consider a "seed" gift to an intentionally defective grantor trust (IDGT)—a trust that is a grantor trust for income tax purposes but the assets

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3. *See id.*

4. *See id.*

5. *See Understanding Estate Taxes*, EST. PLAN., http://www.estateplanning.com/understanding-estate-taxes/ (last visited Nov. 15, 2014).

6. *See id.*

7. *See Income and Estate Taxes: The Need for a Holistic Approach to a Chronic Condition*, *supra* note 2.

8. Consisting of maximum federal long-term capital gain tax rate of 28% and ordinary income tax rate of 39.1%, New York state income tax rate of 6.85%, and a New York City income tax rate of 3.59%. The effective combined tax rate depends, in part, on whether the taxpayer is in the alternative minimum tax, and the marginal tax bracket of the taxpayer.

9. *See* Stephan M. Breitstone, *Estate Planning for Investment Real Estate: Don't Forget the Income Tax Side*, ANCHIN, http://www.anchin.com/upload/News/173509172013_News_LFVS-NYLJevent_EstateGiftTaxPlanning.pdf (last visited Nov. 15, 2014).

10. *See id.*

11. *See, e.g.*, Stuart M. Horwitz & Jason S. Damicone, *Creative Uses of Intentionally Defective Irrevocable Trusts*, 35 EST. PLAN. 35 (2008); Michael D. Mulligan, *Sale to Defective Grantor Trusts: An Alternative to a GRAT*, 23 EST. PLAN. 3 (2006).

of which would not be includible in the estate of the grantor—to support the promissory note issued as part of an installment sale to the IDGT.[12]

(c) The estate planner would draft the trusts and other estate planning structures to avoid estate tax inclusion for as many generations as possible.[13] For example, consider leveraging the generation-skipping transfer (GST) tax exemption by applying it to the seed gift, to the IDGT, and establishing the trust in a jurisdiction that has abolished the rule against perpetuities.[14]

(d) The taxpayer would forego the step-up in basis adjustment at death on the assets that have been transferred during lifetime, because the transfer tax savings were almost certainly much greater than any potential income tax savings that might result from the basis adjustment at death.[15]

(e) The estate planner would take into consideration that the income tax consequences of the various estate planning techniques were appropriately secondary to avoiding the transfer tax.[16]

(f) The state of residence of the decedent and the decedent's beneficiaries would not significantly affect the foregoing recommendations or ideas because of the large gap between the transfer tax and the income tax existing consistently across all of the states.[17]

As a result, there was an enormous amount of consistency in the estate planning recommendations across the United States; the only differentiating factor was the size of the gross estate.[18] In other words, putting aside local law distinctions like community versus separate property, almost all $20 million dollar estates had essentially the same estate plan (using the same techniques in similar proportions).[19]

The enactment of ATRA marked the beginning of a "permanent" change in perspective on estate planning for high net worth individuals.[20] The large gap between the transfer and income tax rates—which was the mathematical reason for aggressively transferring assets during lifetime—has narrowed considerably, and in some states there is virtually no difference in the rates.[21] With ATRA's very generous applicable exclusion provisions, the focus of estate planning will become less about avoiding the transfer taxes and more about avoiding income taxes.[22]

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12. I.R.C. §§ 671–79 (2012); *see also* Horwitz & Damicone, *supra* note 11; Mulligan, *supra* note 11.
13. *See* Jane C. Gravelle, *The Estate and Gift Tax Provision of the American Taxpayer Relief Act of 2012*, CONG. RES. SERVICE 3 (Feb. 15, 2013), http://www.fas.org/sgp/crs/misc/R42959.pdf.
14. *See id.*
15. Stephen M. Margolin & Lindsey Paige Markus, *Estate Tax Relief, Income Tax Headache: Estate Planning and the American Taxpayer Relief Act*, 102 ILL. B.J. 92 (Feb. 2014).
16. *See* Horwitz & Damicone, *supra* note 11; Mulligan, *supra* note 11.
17. *See id.*
18. *See id.*
19. *See id.*
20. *See id.*
21. *See id.*
22. *See id.*

B. The New Tax Landscape

1. Generally

The new tax landscape for estate planners in 2013 and beyond is transformed by increased income tax rates and the falling transfer tax liability at both the federal and state level.[23] On the federal side, the income and transfer tax provisions that became effective January 1, 2013, were enacted as part of ATRA, PPACA, and HCERA (the 3.8% Medicare tax).[24] Many states increased their income tax rates and a number of states continued the trend of repealing their state death tax (estate and inheritance tax).[25]

For example, the California enactment in 2012 of Temporary Taxes to Fund Education (commonly known as Proposition 30) raised the highest marginal income tax bracket to 13.3%.[26] Also, effective April 1, 2014, New York modified its state estate tax by immediately increasing the state estate tax exemption from $1,000,000 to $2,062,500 per person, and by 2019 the exemption will equal the federal applicable exclusion amount.[27] In July 2013, North Carolina repealed its estate tax, effective for estates of decedents dying on or after January 1, 2013.[28] Additionally, Indiana repealed its inheritance tax, effective for estates of decedents dying on or after January 1, 2013.[29]

A complete discussion of all of the provisions of the federal laws and the state laws is beyond the discussion of this article, so we have limited the discussion to the most relevant provisions.

2. Pertinent Provisions of ATRA

a. Federal Transfer Tax Landscape

i. Summary of the Pertinent Income Tax Provisions

ATRA increased the top estate, gift, and GST tax rate to 40%[30] and retained the basic applicable exclusion amount (sometimes referred to as the "Applicable Exclusion Amount" or the "Applicable Exclusion") for each

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23. *See id.*
24. *See id.*
25. *See infra* Part I.B.4.
26. *High-Income Californians May Pay Nation's Highest Income*, SACRAMENTO BEE, http://blogs.sacbee.com/capitolalertlatest/2012/12/high-income-californians-may-pay-nations-highest-tax-rate.html (last visited Oct. 25, 2014).
27. N.Y. St. Dep't of Tax'n & Fin. Op. No. TSB-M-14(6)M (Aug. 25, 2014), *available at* http://www.tax.ny.gov/pdf/memos/estate_&_gift/m14_6m.pdf.
28. North Carolina Tax Simplification and Reduction Act, H.R. 998, 2013 Gen. Assemb. (N.C. 2013).
29. H.R. 1001, 118th Gen. Assemb. (Ind. 2013).
30. I.R.C. §§ 2001(c), 2641(a)(1) (2012) (discussing transfers above $1 million).

individual at $5 million, indexed for inflation after 2011 ($5.34 million for 2014).[31] Additionally, ATRA provided for reunification of the estate, gift, and GST tax system (providing a GST exemption amount equal to the Applicable Exclusion Amount under section 2010(c));[32] permanent instatement of the "portability" of a deceased spouse's unused exclusion amount (DSUE Amount);[33] and repeal of the "sunset" provision with respect the foregoing transfer tax provisions.[34]

ii. Applicable Exclusion Amount

ATRA "permanently" provided for a cost-of-living increase to the Applicable Exclusion Amount, but does not provide for a decrease even in the event of deflation.[35] The Applicable Exclusion Amount can grow to a very large number.[36] The following table is a forecast of the Applicable Exclusion Amount ten and twenty years from now.[37]

FORECASTED APPLICABLE EXCLUSION AMOUNT ($ MILLION)			
	2014	2024	2034
Low Inflation	---	$5.66	$6.37
Median Inflation	$5.34	$6.58	$8.95
High Inflation	---	$8.18	$14.60

31. *Id.* § 2010(c)(2)–(3); Temp. Treas. Reg. § 20.2010-1T(d)(2)–(3) (2012); Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

32. I.R.C. § 2631(c) (2012).

33. *Id.* § 2010(c)(4). Enacted as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (2010) (TRA 2010). Section 101(a)(2) of ATRA struck the "sunset" provisions of TRA 2010 by striking section 304 of TRA 2010. *Id.*

34. Section 101(a)(1) of ATRA provides for the repeal of the "sunset" provision in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The "sunset" provision of EGTRRA is contained in Code section 901 ("All provisions of, and amendments made by, this Act [EGTRRA] shall not apply . . . to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010, [and the] Internal Revenue Code of 1986 . . . shall be applied and administered to years, estates, gifts, and transfers . . . as if the provisions and amendments described [in EGTRRA] had never been enacted."). Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001); I.R.C. § 901 (2012).

35. Temp. Treas. Reg. § 20.2010-1T(d)(3)(ii).

36. *See id.*

37. Low, average, and high inflation are defined as the 90th, 40th, and 10th percentile of inflation over the relevant time periods. These projections are based on Bernstein Global Wealth Management's estimates of the range of returns for the applicable capital markets. Figures are rounded to the nearest $10,000. Data does not represent past performance and is not a promise of actual future results or a range of future results. See Appendix B for additional details.

b. Pertinent Income Tax Provisions

ATRA provided for an increase of the highest federal ordinary income tax bracket to 39.6%;[38] an increase of the highest federal long-term capital gain bracket to 20%;[39] and an increase of the highest federal "qualified dividend income" rate to 20%.[40]

3. The 3.8% Medicare Tax on Net Investment Income

A full and complete discussion of the 3.8% Medicare tax is beyond the scope of this article, but a general understanding is important. Fortunately, there are a number of better resources for that discussion.[41]

For taxable years starting in 2013, section 1411 imposes a 3.8% Medicare tax on "net investment income" (NII).[42] This includes:

(1) "Gross income from interest, dividends, annuities, royalties, and rents" (passive income), other than such passive income that is "derived in the ordinary course of a trade or business" that is not a "Passive Activity or Trading Company" (as defined below);[43]

(2) Gross income derived from a "Passive Activity or Trading Company," which is defined as:

(a) A trade or business that is "a passive activity (within the meaning of section 469) with respect to the taxpayer," or

(b) A trade or business that trades in "financial instruments or commodities (as defined in section 475(e)(2))."[44]

(3) Gain "attributable to the disposition of property other than property held in a trade or business not described" as a Passive Activity or Trading Company;[45] or

(4) Gross income from the investment of working capital.[46]

In arriving at NII, the Code provides for "deductions . . . which are properly allocable to such gross income or net gain."[47]

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38. I.R.C. § 1 (2012) (for individuals with taxable income over $406,750 and married individuals filing jointly with taxable income over $457,600); *see* Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

39. I.R.C. § 1(h)(1)(D) (for individuals with taxable income over $406,750, married individuals filing jointly with taxable income over $457,600, and for estates and trusts with taxable income over $12,150); *see* Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

40. I.R.C. § 1(h)(11) (allowing such income to be considered "net capital gain").

41. *See* Richard L. Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax* (pts 1 & 2), TAX NOTES, Aug. 12, 2013, at 683, TAX NOTES, Aug. 19, 2013, at 785; Blattmachr et al., *Imposition of the 3.8% Medicare Tax on Estates and Trusts*, 40 EST. PLAN. 03 (Apr. 2013).

42. I.R.C. § 1411(c) (2012).

43. *Id.* § 1411(c)(1)(A).

44. *Id.* § 1411(c)(2)(A), (B).

45. *Id.* § 1411(c)(1)(A)(iii).

46. *Id.* § 1411(c)(3) (referencing section 469(e)(1)(B), which provides "any income, gain, or loss which is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business."); *see* Treas. Reg. § 1.1411-6(a) (2013).

47. I.R.C. § 1411(c)(1)(B).

For individuals, the 3.8% Medicare tax is imposed on the lesser of: NII; or the excess of "modified adjusted gross income for such taxable year" (MAGI), over the "threshold amount" ($200,000 for individual taxpayers, 250,000 for joint taxpayers, and $125,000 for married taxpayers filing separately).[48] For estates and trusts, the 3.8% Medicare tax is imposed on the lesser of: "[T]he undistributed net investment income for such taxable year; or the excess (if any) of the adjusted gross income (as defined in section 67(e)) for such taxable year, over the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year [($12,150 of taxable income for 2014)]."[49] The threshold amount for individuals does not increase with cost-of-living adjustments, but the taxable income amount threshold for trusts and estates does.[50]

With respect to a disposition of a partnership interest or S corporation shares, the net gain will be subject to the 3.8% Medicare tax but "only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest."[51]

The following are excluded from the definition of NII:

(1) Distributions from "a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A or 457(b)," specifically referring to:

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

(b) A qualified annuity plan under section 403(a);

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

(d) An individual retirement account (IRA) under section 408;

(e) A Roth IRA under section 408A; and

(f) A deferred compensation plan of a state and local government or a tax-exempt organization under section 457(b).[52]

(2) Gain or other types of income that generally would not be taxable under the Code, including:

(a) Interest on state and local bonds (municipal bonds) under section 103;

(b) Deferred gain under the installment method under section 453;

(c) Deferred gain pursuant to a like-kind exchange under section 1031 and an involuntary conversion under section 1033; and

(d) Gain on the sale of a principal residence under section 121.[53]

48. *Id.* § 1411(a)(1)(A), (a)(1)(B)(i)–(ii), (b). Modified adjusted gross income is "adjusted gross income" as adjusted for certain foreign earned income. *Id.* § 1411(d).

49. *Id.* § 1411(a)(2), (a)(2)(B)(i)–(ii); *see* Rev. Proc. 13-35, 2013-47 I.R.B. 537.

50. *Id.* § 1411(a)(2), (a)(2)(B)(i)–(ii); *see* Rev. Proc. 13-35, 2013-47 I.R.B. 537.

51. I.R.C. § 1411(c)(4)(A).

52. *Id.* § 1411(c)(5); Treas. Reg. § 1.1411-8 (2013).

53. *See* Treas. Reg. § 1.1411 (2013).

The application of the 3.8% Medicare tax to trusts that own closely held business interests is controversial, and there is considerable uncertainty as to how a fiduciary that owns interests in a closely held business can materially participate and thereby avoid the imposition of the tax.[54] In *Mattie K. Carter Trust v. U.S.*, the court held that in determining material participation for trusts the activities of the trust's fiduciaries, employees, and agents should be considered.[55] The government argued that only the participation of the fiduciary ought to be considered, but the court rejected that argument.[56] In *Frank Aragona Trust v. Commissioner*, the tax court held that the trust qualified for the real estate professional exception under section 469(c)(7) (deemed material participation) because three of the six co-trustees were full time employees of the trust's wholly-owned LLC that managed the rental properties.[57] In addition, the tax court also considered the activities of co-trustees that had co-ownership interests in the entities held by the trust, reasoning that the interests of the co-trustees were not majority interests, were never greater than the trust's interests in the entities, and were compatible with the trust's goals.[58]

Notwithstanding the foregoing, the IRS ruling position is that only the fiduciary's activities are relevant. The IRS reaffirmed this ruling position in Technical Advice Memorandum 2013-17-010.[59] The ruling explains the IRS rationale as follows:

> The focus on a trustee's activities for purposes of § 469(h) is consistent with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employee's [sic] to satisfy the material participation requirement. *See* S. Rep. No. 99-313, at 735 (1986) ("the activities of [employees] . . . are not attributed to the taxpayer."). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An interpretation that renders part of a statute inoperative or superfluous should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).[60]

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54. *See id.*
55. Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536, 542 (N.D. Tex. 2003).
56. *Id.* at 539.
57. Frank Aragona Trust v. Comm'r, 142 T.C. 9, 9 (2014).
58. *See id.* at 8.
59. *See* I.R.S. Tech. Adv. Mem. 2013-17-010 (Jan. 18, 2013).
60. *See id.*; *see also* I.R.S. Tech. Adv. Mem. 07-33-023 (Aug. 17, 2007); I.R.S. Priv. Ltr. Rul. 10-29-014 (July 23, 2010) (explaining the duties of a special trustee).

At issue in the ruling were the activities of "special trustees" who did the day-to-day operations and management of the companies in question but lacked any authority over the trust itself.[61] The ruling states:

> The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.[62]

The need for a trustee to be active may affect the organization of business entities held in trust.[63] For instance, a member-managed LLC may be more efficient than a manager-managed LLC, unless a fiduciary is the manager.[64]

In addition, it is unknown how the IRS will apply the 3.8% Medicare tax to charitable remainder trusts (CRT), particularly when dealing with commercial real property, and how the income and gain therefrom will be taxed to the noncharitable beneficiary of the CRT.[65] Because commercial real property is depreciable, planners should be aware of how the sale of such property in a CRT will affect the taxation of the distribution under the "tier" rules.[66] Generally, the sale of most commercial real property will give rise to "unrecaptured § 1250 gain," which is taxed at a maximum federal rate of 25%.[67] As a result, if commercial real property is sold in a CRT, the tier rules include gain taxed at 25%, as well as regular long-term gains at 20%.[68] In

61. *See* I.R.S. Tech. Adv. Mem. 2013-17-010 (Jan. 18, 2013).

62. *Id.*

63. *See id.*; I.R.S. Tech. Adv. Mem. 07-33-023 (Aug. 17, 2007); I.R.S. Priv. Ltr. Rul. 10-29-014 (July 23, 2010) (explaining the duties of a special trustee).

64. *See* I.R.S. Tech. Adv. Mem. 07-33-023 (Aug. 17, 2007).

65. I.R.C. § 664 (2012).

66. *Id.* § 664(b).

67. *Id.* § 1(h)(1)(E), (h)(6)(A) (explaining that unrecaptured section 1250 gain is defined as "the amount of long-term capital gain that would be treated as ordinary income if Section 1250(b)(1) included all depreciation and the applicable percentage under Section 1250(a) were 100%"). This convoluted definition essentially provides that the aggregate straight-line depreciation taken on the property will be considered unrecaptured section 1250 gain. *Id.* § 1(h)(6)(A). Under the current depreciation system, straight-line depreciation is required for all residential rental and nonresidential real property. *Id.* § 168(b)(3)(A)–(B).

68. I.R.S. Notice 99-17, 199-14 I.R.B. 6.

addition, any gains and rental income from the property may or may not be considered NII, depending on the active (material participation) or passive participation of the parties involved (donor, recipient, or trustee) and the property in question.[69] It is unclear at this point how and whether the activities of the donor, recipient, or trustee will cause all or a portion of the income and gain attributable to the real property to be excluded or subject to the 3.8% Medicare tax when distributed from the CRT.[70] Many questions remain unanswered. For example, if the trustee is an active participant on the rental property, does that immediately exclude all of the gain and income even if the donor/recipient is not materially participating? If the donor is an active participant on the property prior to contribution, does that mean all of the gain on a subsequent sale by the trustee of the CRT is excluded from the NIIT? Or does that mean only precontribution gain is excluded and postcontribution gain is NII? What if the active donor is also the sole trustee or co-trustee of the CRT?

4. Disparity Among the States

The state estate and inheritance tax (state death tax) landscape has changed significantly since 2001 when almost every state had an estate tax, an inheritance tax, or both that was tied to the—then existing— federal state death tax credit.[71] As the law stands today, the federal state death tax credit has been replaced by a federal estate tax deduction under section 2058, and only seventeen states still retain a generally applicable death tax.[72] In those states with a death tax, the rates and exemption can vary significantly. For example, Washington's estate tax provides for a top rate of 20% and an exemption of $2 million per person (indexed for inflation starting January 1, 2014, but only for the Seattle-Tacoma-Bremerton metropolitan area).[73] Pennsylvania, on the other hand, provides for an inheritance tax rate of 4.5% for transfers to descendants and has almost no exemption.[74] When taken in

69. *See* Treas. Reg. § 1.1411-4 (2013). The Treasury Department did not issue formal guidance on how the material participation will be determined in the final Treasury regulations issued in 2013. It is unclear whether material participation will be determined at the trustee, donor, or recipient level.

70. The Treasury regulations provide that the taxpayer's activities conducted through C corporations, partnerships, and S corporations can be grouped for passive activity (and NIIT) purposes. *See* Treas. Reg. § 1.469-4 (as amended in 1995). Trusts are excluded. *Id.*

71. *See* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001) (EGTRRA). Sections 531 and 532 of EGTRRA provided for a reduction of, and eventual repeal of, the federal estate tax credit for state death taxes under section 2011, replacing the foregoing with a deduction under section 2058. *See id.*

72. Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, and Washington. Iowa and Kentucky have an inheritance tax, but the exemption to lineal heirs is unlimited. *See* Joel Michael, *Estate and Inheritance Taxation: An Overview of Taxes in State*, HOUSE RES. (July 2014), http://www.house.leg.state.mn.us/hrd/pubs/ss/ssestinh.pdf; *see also* I.R.C. § 2058 (2012).

73. WASH. REV. CODE ANN. §§ 83.100.020, 83.100.040 (West 2013).

74. 72 PA. STAT. ANN. § 9116 (West 2001).

conjunction with the transfer tax provisions of ATRA (both the top federal tax rate at 40% and the large Applicable Exclusion Amount), the combined federal and state transfer tax cost to high net worth individuals has significantly fallen, when compared to 2001, by way of example.[75]

State and local income tax laws and rates vary as well.[76] A number of states have no state and local income tax (Florida, Texas, Nevada, New Hampshire, and Washington) and other states (California, Hawaii, Minnesota, New Jersey, New York, and Oregon) have relatively high income tax rates.[77] When taken in conjunction with the income tax provisions of ATRA and the 3.8% Medicare tax, the combined federal and state income tax cost to most taxpayers has significantly risen since 2001.[78]

Thus, the new estate planning landscape is characterized by significantly lower transfer tax costs, higher income tax rates, and significant disparity among the states when one compares the two taxes.[79] As mentioned above, in 2001, for a New York City resident there was a 25% difference between the maximum transfer tax rate and the long-term capital gain tax rate. Today, that difference is approximately 13%.[80] In contrast, consider the tax rates in California. Because California does not have a state death tax, but currently has the highest combined income tax rate in the United States, the difference between the transfer tax rate and the long-term capital gain tax rate is less than 3%.[81] Notably, the top combined ordinary and short-term capital gain tax rate in California is greater (approximately 45% to 53%) than the transfer tax rate.[82] You will find a summary of the current state income and death tax rates in Appendix A (Summary of State Income and Death Tax Rates).[83]

If one considers the "gap" (the difference between the transfer tax and the income tax rates) as a proxy for how aggressively estate planners will consider transferring assets out of the estate during their lifetime, then one can see large differences among the states.[84] For example, on one side is California, where there is a very small or negative difference, compared to Washington,

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75. *See supra* Part I.A.

76. *State Individual Income Taxes*, FED'N TAX ADMIN., http://www.taxadmin.org/ftq/rate/ind-inc.pdf (last visited Nov. 7, 2014).

77. *See id.*

78. *See supra* Part I.A.

79. *See infra* Part I.B.

80. *See Facts & Figures: How Does Your State Compare*, TAX FOUND. (2014), http://taxfoundation.org/sites/taxfoundation.org/files/docs/Facts%20and%20Figures%202014.pdf. New York has a maximum estate tax rate of 16%, when added to the maximum federal tax rate of 40% and deducted pursuant to section 2058, the combined maximum transfer tax rate is 49.6%, compared to a maximum long-term capital gain tax rate of 36.5% for New York City taxpayers in the alternative minimum tax (20% federal, 3.8% Medicare tax, 8.82% state, and 3.88% local).

81. *See id.* Combined long-term capital gains tax rate of 37.1% for California taxpayers in the alternative minimum tax (20% federal, 3.8% Medicare tax, and 13.3% state).

82. *See id.*

83. *See infra* Appendix A.

84. *See supra* Part I.A.

where there is a very large gap (approximately 28% difference above the long-term capital gain tax rate).[85]

As a result, a reasonable prediction is that the consistency that has existed across the United States for similarly situated clients—distinguished only by the size of the potential gross estate—will exist no longer.[86] Instead, estate plans will vary based on the state of residence of the client.[87] For example, arguably California residents should be more passive in their estate plans, choosing more often than not to simply die with their assets, than Washington residents.[88] This is because the income tax savings from the step-up in basis may, in fact, be greater than the transfer tax cost, if any.[89]

C. The New Paradigm in Estate Planning

Given how large the Applicable Exclusion Amount will be in the future, it is clear that the focus of estate planning will increasingly move away from avoiding the transfer tax and become more focused on the income tax.[90] Much of the estate planning analysis will be about measuring the transfer tax cost against the income tax savings of allowing the assets to be subject to federal and state transfer taxes.[91] A new "paradigm" in estate planning might have the following features:

(a) Estate plans will vary significantly based upon many more variables, including: time horizon or life expectancy of the client; spending or lifestyle of the client, including charitable giving; size of the gross estate; future return of the assets; tax nature of the types of assets (for example, to what extent will a step-up in basis benefit the client and the beneficiaries?); expected income tax realization of the assets (for example, when is it likely that the asset will be subject to a taxable disposition?); state of residence of the client; state of residence and marginal income tax bracket of the likely beneficiaries; and expectations about future inflation.[92]

(b) Estate planners will seek to use as little of a client's Applicable Exclusion Amount as possible during their lifetime because it will represent an ever-growing amount that will provide a step-up in basis with little or no

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85. Washington does not have a state income tax. *See Facts & Figures: How Does Your State Compare*, *supra* note 80.

86. *See supra* Part I.A–B.

87. *See supra* Part I.A–B.

88. *See Facts & Figures: How Does Your State Compare*, *supra* note 80.

89. *See id.*

90. Louis S. Harrison & John M. Janiga, *Income Tax v. Estate Tax Planning*, HARRISON & HELD (Oct. 2014), http://www.harrisonheld.com/sites/default/files/HarrisonColumn.pdf.

91. *See id.*

92. *See* Nicholas J. Houle & Dominic J. Zamora, *Estate Planning After the American Taxpayer Relief Act (ATRA) of 2012*, CLIFTON LARSON ALLEN (Feb. 8, 2014), http://www.claconnect.com/private-client/wealth-advisory/presentation-slides-estate-planning-after-the-american-taxpayer-relief-act-(atra)-2012.aspx.

transfer tax cost at death.[93] This conclusion assumes that "zeroed-out" estate planning techniques, like installment sales to IDGTs, and/or zeroed-out grantor retained annuity trusts (GRATs) can accomplish effectively the same amount of wealth transfer as a taxable gift but without using any, or a significant portion, of a client's Applicable Exclusion Amount.[94] Wealth transfer is not accomplished when a taxpayer makes a gift and uses his or her Applicable Exclusion Amount toward that gift.[95] There is wealth transfer only if and when the asset appreciates (including any appreciation effectively created by valuation discounts).[96] That is essentially the same concept as an installment sale to an IDGT and a GRAT, except that those techniques require appreciation above a certain rate, like the applicable federal rate (AFR) or the section 7520 rate.[97]

(c) Because the step-up in basis may come at little or no transfer tax cost, estate planners will seek to force estate tax inclusion in the future.[98]

(d) The state of residence of the client and his or her beneficiaries will influence the estate plan.[99] For instance, if a client is domiciled in California, and his or her beneficiaries live in California, then dying with the assets may be the extent of the tax planning.[100] On the other hand, if the beneficiaries live in a state like Texas that has no state income tax, then transferring the assets out of the estate during the lifetime of the client may be warranted.[101] As a result, estate planners will need to ask clients two questions that, in the past, did not significantly matter: Where is your domicile likely to be at your death?; and when that occurs, where is it likely that your beneficiaries (children and grandchildren) will reside?

D. Portability and the New Paradigm

The newest feature on the estate planning landscape is portability.[102] A full discussion of the planning implications of portability is beyond the scope of

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93. *See* John J. Scroggin, *Income Tax and Basis Planning in the Context of Estate Planning*, SCROGGIN LAW (June 2005), http://www.scrogginlaw.com/Income.shtml.

94. *See generally* Treas. Reg. § 25.2702-3(b) (as amended in 2005) (defining GRATs as a trust that provides the grantor with a qualified annuity interest and discussing trusts that provide the grantor with a "qualified annuity interest" under Treas. Reg. § 25.2702-3(b)).

95. *See* Cherry Bekaert, *Wealth Transfer and Other Planning Opportunities in Down Market*, CHERRY BEKART (Oct. 19, 2013), www.cbh.com/wealth-transfer-and-other-planning-opportunities-in-down-market-2/.

96. *See id.*

97. I.R.C. §§ 1274, 7520 (2012).

98. Martin M. Shenkman, *Income Tax Tips and Estate Planning*, CPA TAX MAG., http://www.cpataxmag.net/shenkman-stories/51-columnist-martin-m-shenkman/213-income-tax-tips-and-estate-planning (last visited Nov. 8, 2014).

99. *See id.*

100. *See State Individual Income Taxes*, *supra* note 76.

101. *See id.*

102. *See* Richard S. Franklin et al., *Portability: The Game Changer*, A.B.A. REAL PROP. TR. & EST. 1 (January 2013), http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/heckerling/2013/portability_the_game_changer_2013_01_15_paper_2.authcheckdam.pdf.

this article and there are resources publicly available that cover the subject in a comprehensive manner.[103] In the context of the "new paradigm" in estate planning discussed above, portability (at least in theory) can provide additional capacity for the surviving spouse's estate to benefit from a step-up in basis with little or no transfer tax costs.[104]

In traditional by-pass trust planning, upon the death of an individual who has a surviving spouse, assets of the estate equal in value to the decedent's unused Applicable Exclusion Amount fund a trust (typically for the benefit of the surviving spouse).[105] The trust is structured to avoid estate tax inclusion in the surviving spouse's estate.[106] Any assets in excess of the unused Applicable Exclusion Amount fund the marital deduction portion.[107] The by-pass trust avoids estate tax inclusion in the surviving spouse's estate.[108] From an income tax standpoint, however, the assets in the by-pass trust do not receive a step-up in basis upon the death of the surviving spouse.[109] Furthermore, while the assets remain in the by-pass trust, any undistributed taxable income above $11,950 of taxable income will be subject to the highest income tax rates at the trust level.[110]

In portability planning, the decedent's estate would typically pass to the surviving spouse under the marital deduction, and the DSUE Amount would be added to the surviving spouse's Applicable Exclusion Amount.[111] Because the estate will be subject to estate taxes at his or her death, all of the assets passing from the decedent to the surviving spouse, in addition to the spouse's own assets, will receive a step-up in basis.[112] Additional income tax benefits might be achieved if the assets that would otherwise have funded the by-pass trust are taxed to the surviving spouse, possibly benefiting from being taxed at a lower marginal income tax bracket.[113] In addition, if the by-pass trust would have been subject to a high state income tax burden (for example, California), then having the assets taxed to a surviving spouse who moves to a low or no income tax state would provide additional income tax savings over traditional by-pass trust planning.[114]

Of course, there are other considerations, including creditor protection and "next spouse" issues, that would favor by-pass trust planning.[115] However,

103. *See id.*
104. *See id.*
105. *See* BONNIE J. LAWLESS, TAX ADVISORS PLANNING SYSTEM § 33:4.01 (2014).
106. *See id.*
107. *See id.*
108. *See id.*
109. *See id.*
110. *See* Rev. Proc. 2013-15, 2013-5 I.R.B. 444, § 2.01.
111. I.R.C. § 2010(c)(2) (2012).
112. *See* Franklin, *supra* note 102, at 6.
113. *See id.* at 5.
114. *See id.* at 8.
115. *See* Steve R. Akers, *Portability Planning Considerations*, SU002 A.L.I. CONTINUING LEGAL EDUC. 1157 (2013).

from a tax standpoint, the trade-off is the potential estate tax savings of traditional by-pass trust planning against the potential income tax savings of portability planning.[116] Because the DSUE Amount does not grow with the cost-of-living index, very large estates ($20 million or above, for example) will benefit more with traditional by-pass trust planning because all of the assets, including any appreciation after the decedent's death, will pass free of transfer taxes.[117] On the other hand, smaller but still significant estates (up to $7 million, for example) should consider portability as an option because the combined exclusions—the DSUE Amount frozen at $5.34 million and the surviving spouse's Applicable Exclusion Amount of $5.34 million, but growing with the cost-of-living index—are likely to allow the assets to pass at the surviving spouse's death with a full step-up in basis and little or no transfer tax costs (unless the assets are subject to significant state death taxes at that time).[118]

In evaluating the income tax savings of portability planning, planners will want to consider that, even for very large estates, the surviving spouse has the option of using the DSUE Amount by making a taxable gift to an IDGT.[119] The temporary Treasury regulations make clear that the DSUE Amount is applied against a surviving spouse's taxable gift first, before reducing the surviving spouse's Applicable Exclusion Amount (referred to as the basic exclusion amount).[120] The IDGT would provide the same estate tax benefits as the by-pass trust would have, but importantly, the assets would be taxed to the surviving spouse as a grantor trust, thus allowing the trust assets to appreciate out of the surviving spouse's estate without the burden of income taxes.[121] If the assets appreciate then this essentially solves the problem of the DSUE Amount freezing in value.[122] Moreover, if the IDGT provides for a power to exchange assets of equivalent value with the surviving spouse, the surviving spouse can exchange high-basis assets for low-basis assets of the IDGT prior to death and essentially effectuate a step-up in basis for the assets in the IDGT.[123] The ability to swap or exchange assets with an IDGT is discussed in more detail below.

Portability planning is slightly less appealing to couples in community property states because, as discussed below, all community property gets a step-up in basis on the first spouse's death.[124] Thus, the need for additional

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116. *See id.*
117. *See* Franklin, *supra* note 102, at 9.
118. *See id.*
119. *See* Akers, *supra* note 115.
120. Treas. Reg. § 25.2505-2T(d) (2012).
121. *See* Rev. Rul. 2004-64, 2004-2 C.B. 7.
122. Andrew Pharies, *Portability: The Basics and Beyond*, CV032 A.L.I. CONTINUING LEGAL EDUC. 1013 (2014).
123. I.R.C. § 675(4)(C) (2012); Rev. Rul. 85-13, 1985-1 C.B. 184; I.R.S. Priv. Ltr. Rul. 95-35-026 (Sept. 1, 1995).
124. I.R.C. § 2056 (2012).

transfer tax exclusion in order to benefit from a subsequent step-up in basis is less crucial.[125] This is not true, however, for assets that are depreciable (commercial real property) or depletable (mineral interests).[126] As discussed below, these types of assets will receive a step-up in basis but, over time, the basis of the asset will be reduced by the ongoing depreciation deductions.[127] As such, even in community property states, if there are significant depreciable or depletable assets, portability should be considered.[128]

II. TRANSFER TAX COST VS. INCOME TAX SAVINGS FROM THE "STEP-UP"

A. Generally

One of the first steps when analyzing a client's situation is trying to measure the potential transfer tax costs against the income tax savings that would arise from a step-up in basis.[129] Under the current state of the law, this is not an easy endeavor.[130] First, the Applicable Exclusion Amount will continue to increase.[131] Both the rate of inflation and the lifespan of the client are outside the planner's control.[132] In addition, as mentioned in the previous section, if the client dies in a state that has a death tax, the calculation of the transfer tax cost will be complicated by that state's exemption and death tax rate.[133] Third, the income tax savings of the step-up in basis must be measured in relation to the beneficiaries who may live in a different state than the decedent.[134]

Although a step-up in basis is great in theory, no tax will be saved if the asset is at a loss at the time of death resulting in a "step-down" in basis, the asset has significant basis in comparison to its fair market value at the time of death, or the asset will not benefit at all because the IRS considers it as income in respect of a decedent (IRD).[135] Furthermore, even if the assets will benefit from a significant step-up in basis, the only way to capture the income tax benefits of the basis adjustment is to sell the asset in a taxable disposition.[136] Many assets, like family-owned businesses, may never be sold or may be sold so far in the future that the benefit of a step-up is

125. *See infra* Part II.C.
126. *See infra* Part II.C.
127. I.R.C. § 1014 (2012).
128. *See* Pharies, *supra* note 122.
129. *See* Steve R. Akers, *Estate Planning: Recent Developments and New Planning Paradigms,* CW005 A.L.I. CONTINUING LEGAL EDUC. 297 (2014).
130. *See id.*
131. I.R.C. § 2010(c)(2) (2012).
132. *See id.* § 2010(c)(3).
133. *See supra* Part I.D.
134. *See supra* Part I.D.
135. I.R.C. § 691 (2012).
136. *See id.*

attenuated.[137] In addition, even if the asset will be sold, there may be a significant time between the date of death of the decedent—when the basis adjustment occurs—and the taxable disposition, so some consideration should be given to quantifying the cost of the deferral of the tax savings.[138] Finally, the nature of the asset may be such that even if the asset will not be sold in a taxable disposition, it may confer economic benefits to the beneficiaries.[139] For example, if the asset that receives a step-up in basis is either depreciable or depletable under the Code, the deductions that arise do result in tax benefits to the owners of that asset.[140] In addition, an increase in the tax basis of an interest in a partnership or in S corporation shares may not provide immediate tax benefits, but they do allow additional capacity of the partner or shareholder to receive tax-free distributions from the entity.[141] These concepts and how certain assets benefit or do not benefit from the basis adjustment at death are discussed in more detail below.[142]

B. Transfer Tax Cost: State of Domicile, Spending, Time Horizon

By way of example, consider a couple with a relatively large estate, $20 million. Although we cannot explore all the variables that might affect this situation, we will look at a few: the decedent's state of domicile, time horizon, and spending. Assume for purposes of this exercise:

(1) 50% of the assets are appreciating (modeled as global equities), and 50% have limited appreciation potential (modeled as fixed income);

(2) The couple has both of their Applicable Exclusion Amounts fully available; and

(3) There is no significant time difference between the deaths of each of them (thereby simplifying the issue of how by-pass/credit shelter trust planning or electing portability under section 2010(c)(5)(A) would change the overall tax picture).[143]

The variables are:

(1) Domicile in California or New York;

(2) Time horizon (date of death of the surviving spouse) of ten or twenty years; and

137. *See* Akers, *supra* note 129.

138. *See id.*

139. *See id*.

140. *See, e.g.*, I.R.C. § 1016(a)(2) (2012).

141. *See, e.g.*, *id.* §§ 731(a)(1), 1368(b).

142. *See infra* Part V.

143. *See* I.R.C. § 2010(c) (2012). Generally referring to a trust that is created upon the first spouse's death, which is not subject to federal estate tax by virtue of the deceased spouse's Applicable Exclusion Amount and which is generally created for the benefit of the remainder of the surviving spouse's lifetime, but is not subject to federal estate tax in the surviving spouse's estate.

(3) Spending $600,000 (3% of the initial value), $800,000 (4%), or $1,000,000 (5%), after tax, grown with inflation.[144]

The following table shows our forecast of the probabilities of a federal estate tax liability (a gross estate greater than the joint Applicable Exclusion Amounts), if the couple is domiciled in California:[145]

Probability of a Federal Estate Tax Liability (Current $20 Mil. California Residents)		
Spending	Year 10	Year 20
3% ($600k)	94%	72%
4% ($800k)	87%	46%
5% ($1 mil.)	74%	22%

Note how spending and time horizon significantly affect whether there is a high or low probability of a federal estate tax liability.

The following table shows our forecast of the probabilities of a federal estate tax liability (a gross estate greater than the joint Applicable Exclusion Amounts), if the couple is domiciled in New York (specifically New York City):

Probability of a Federal Estate Tax Liability (Current $20 Mil. New York City Residents)		
Spending	Year 10	Year 20
3% ($600k)	94%	68%
4% ($800k)	86%	41%
5% ($1 mil.)	71%	18%

Note the probability of a state estate tax liability is 100% because New York provides for a $1 million exemption per person.[146] Please also note the probabilities are very similar to the California scenario. The only difference results from slightly different income tax rates.[147]

144. *See id.* §§ 2501–05.

145. *Planning for the Sale of a Business: Notes on Wealth Forecasting Systems*, ALLIANCE BERNSTEIN (2009), https://www.alliancebernstein.com/abcom/Opportunity/Selling_A_Business/Content/SAB_WFS_Notes.pdf (relying upon Bernstein Global Wealth Management's proprietary analytical tool that marries the benefits of stochastic modeling with our structural model of the capital markets). In each scenario Bernstein simulated 10,000 market scenarios or forecasts for the next twenty years, based initially upon the current state of the capital markets. *See id.* Bernstein's proprietary capital markets engine and wealth forecasting model uses proprietary research and historical data to create a wide range of possible market returns for many asset classes over the coming decades, following many different paths of return. *See id.* The model takes into account the linkages within and among different asset classes in the capital markets and incorporates an appropriate level of unpredictability or randomness for each asset class. *See id.*

146. N.Y. TAX LAW § 951 (McKinney 2014).

147. *Compare* CAL. REV. & TAX CODE § 17041 (West 2014) (detailing California income tax rates), *with* N.Y. TAX LAW § 601 (McKinney 2014) (detailing the New York income tax rates).

While the probabilities of a federal estate tax liability are interesting, the more telling information comes from determining the magnitude of the estate tax liability. In this context, the total estate tax liability should be couched in terms of an "effective" death tax rate.[148] In California, the marginal estate tax rate is obviously 40%, but it will only be 40% of the excess value above the joint Applicable Exclusion Amounts at date of death.[149] Because the step-up in basis is based upon fair market value of the assets, the "effective" estate tax cost should be couched in terms of the fair market value of the assets (not just a dollar amount).[150] For example, if the gross estate is $22 million and the joint Applicable Exclusion Amounts are $12 million at the date of death, then the estate tax liability is $4 million (40% × $10 million) and the "effective" estate tax rate is 18.2% ($4 million ÷ $22 million).[151]

The average "effective" estate tax rates (when there is an estate tax liability) for the $20 million California couple, based on our forecasts are:[152]

"Effective" Estate Tax Rate (Current $20 Mil. California Residents)		
Spending	Year 10	Year 20
3% ($600k)	16%	11%
4% ($800k)	13%	7%
5% ($1 mil.)	8%	3%

The average "effective" estate tax rates (including New York's estate tax, but with $2 million of joint state estate tax exemption) for the $20 million New York City couple, based on our forecasts are:[153]

"Effective" Estate Tax Rate (Current $20 Mil. New York City Residents)		
Spending	Year 10	Year 20
3% ($600k)	24%	17%
4% ($800k)	20%	12%
5% ($1 mil.)	15%	8%

How might this data affect planning today? Assume we are dealing with a $20 million couple, spending 3%, and with a joint life expectancy of at least ten years but likely not twenty. Based on the foregoing tables, although the probabilities of an estate tax liability are high, the average "effective" death tax

148. REV. & TAX § 17041; TAX § 601.
149. REV. & TAX § 17731.
150. *See 2014 Estate and Tax Planning*, BLANK ROME (Feb. 2014), http://www.blankrome.com/index.cfm?contentID=37&itemID=3254.
151. *See id.*; REV. & TAX § 17731.
152. REV. & TAX § 17731.
153. *See* N.Y. TAX LAW § 951 (McKinney 2013).

cost is 16% (California) and 24% (NYC). Whether that liability is too high or too low depends, in large part, on the nature of the types of assets that are likely to be in the estate at the date of death.[154]

For example, if it is likely that a large portion of the estate will be comprised of zero-basis long-term capital gain assets, then an "effective" estate tax cost of 16% (California) or 24% (New York) might be a fair price to pay because a taxable sale of that asset without a step-up in basis would cause an income tax liability equal to 37.1% (California income tax rate) and 36.5% (New York City income tax rate) of the value of the assets.[155] This trade-off becomes even more compelling when the asset is a zero-basis asset that would be taxed at ordinary tax rates but would benefit from a step-up in basis, like intangible assets or intellectual property (copyrights and trademarks).[156] These types of considerations are discussed in more detail in the following section.

When the income tax savings from the step-up in basis are sufficient to justify paying the transfer tax cost, the need for ensuring liquidity to pay the transfer tax liability becomes crucial. While the general trend for the future portends increasingly less transfer tax liability, the need for life insurance (and irrevocable life insurance trusts) continues in this new planning landscape.

C. Community Property Considerations

Given the central role the step-up in basis has in estate planning now, community property states have a significant advantage over separate property states because both the decedent's and the surviving spouse's one-half interest in community property will receive a basis adjustment to fair market value under section 1014(b)(6).[157] Because the unlimited marital deduction under section 2056 essentially gives couples the ability to have no transfer taxes on the first spouse's death, this step-up in basis provides an immediate income tax savings for the benefit of the surviving spouse (rather than the subsequent beneficiaries).[158]

This theoretically provides a bifurcated approach to estate planning for spouses in community property states:

(1) During the lifetimes of both spouses, limit *inter vivos* transfers and maximize the value of the assets in order to benefit the most from the basis adjustment under section 1014(b)(6).[159]

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154. *See id.*

155. *Compare* CAL. REV. & TAX CODE § 17041 (West 2014), *with* N.Y. TAX LAW § 601 (McKinney 2013).

156. *See infra* Part III.

157. *See* I.R.C. § 1014(b)(6) (2012).

158. *See id.* §§ 1014, 2056.

159. *See id.* § 1014(b)(6).

(2) During the lifetime of the surviving spouse, with assets in excess of the Available Exclusion Amount (taking into account any amounts that might have been ported to the surviving spouse), transfer as much wealth as possible out of the estate through *inter vivos* transfers and other estate planning techniques.[160] Further, through the use of family limited partnerships (FLPs) and other techniques, attempt to minimize the transfer tax value of the assets that would be includible in the estate of the surviving spouse.[161]

Notably, with the U.S. Supreme Court's declaration that Section 3 of the Defense of Marriage Act (DOMA) is unconstitutional, pursuant to its decision in *United States v. Windsor*, and the issuance of Revenue Ruling 2013-17, the tax ramifications are far reaching for clients in states like California where community property and same-sex marriage laws exist.[162]

The basis adjustment at death for community property and other planning considerations, including electing into community property status, are discussed in more detail later in this article.

III. SECTION 1014 AND THE TAX NATURE OF CERTAIN ASSETS

A. General Rule: The "Step-Up" in Basis to Fair Market Value

Generally, under section 1014(a)(1), the "basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent" is the "fair market value of the property at the date of the decedent's death."[163] The foregoing general rule is often referred to as the "step-up" in basis at death, under the assumption that assets generally appreciate in value.[164] However, many assets depreciate in value, and this general rule will mean a loss of tax basis to fair market value at the date of death (a "step-down" in basis).[165] For purposes of this article, we refer to the general rule of section 1014(a)(1) as a step-up in basis, whether the asset is appreciated or at a loss at the time of the decedent's death.[166]

The Code goes on to say that if the executor of the estate elects an alternate valuation date under section 2032 or special use valuation under section 2032A, then the basis is equal to the value prescribed under those Code sections.[167]

160. *See id.* § 2056(b).
161. *See id.* § 2057(d).
162. 1 U.S.C. § 7 (2012) (section 3 of DOMA defined marriage and spouse as excluding same-sex partners); United States v. Windsor, 133 S. Ct. 2675, 2682 (2013); Hollingsworth v. Perry, 133 S. Ct. 2652 (2013); Rev. Rul. 2013-17, 2013-38 I.R.B. 201.
163. I.R.C. § 1014.
164. *See id.*
165. *See id.*
166. *See id.*
167. *Id.* §§ 2032, 2032A, 1014(a)(2)–(3).

If section 2031(c) excludes land or some portion of such land that is subject to a qualified conservation easement from the estate tax, then "to the extent of the applicability of the exclusion" the basis will be the basis in the hands of the decedent (carryover basis).[168]

B. Section 1014(e): The One-Year Conundrum

Section 1014(e) provides that if "appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death" and the property is "acquired from the decedent by (or passes from the decedent to) the donor of such property (or spouse of such donor)," then the property will not receive a step-up in basis, and it will have the basis in the hands of the decedent before the date of death.[169]

For purposes of the foregoing, the Code provides that carryover basis shall apply to any appreciated property "sold by the estate of the donor or by a trust of which the decedent was the grantor," but only "to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale."[170]

This rule does not apply if the property passes to the issue of the original donor, and it is unclear whether this rule applies if the property is placed in a trust in which the original donor or donor's spouse is a potential beneficiary.[171] In *Estate of Kite v. Commissioner*, prior to her husband's death, the surviving spouse funded an *inter vivos* QTIP trust for the benefit of her husband with appreciated assets.[172] Her husband died a week after the QTIP trust was created and funded.[173] The surviving spouse reserved a secondary life estate for the benefit of the surviving spouse, and the inclusion in her husband's estate was offset with a QTIP election.[174] As such, after her husband's death, the appreciated assets were held in a marital trust for the surviving spouse—the original donor of the assets.[175] Two other marital trusts were created for the benefit of the surviving spouse.[176] The three marital trusts engaged in a series of transactions that effectively terminated the marital trusts, with a subsequent sale of the assets by the surviving spouse to the children for a deferred annuity.[177] The tax court concluded that a taxable gift was deemed to occur upon the sale of the marital trust assets under section 2519.[178] However,

168. *Id.* §§ 2032, 2032A, 1014, 1015.
169. *Id.* § 1014(e)(1)(A).
170. *Id.* § 1014(e)(2)(B).
171. *See* I.R.S. Priv. Ltr. Rul. 2002-10-051 (Mar. 8, 2002); I.R.S. Priv. Ltr. Rul. 2001-01-021 (Jan. 5, 2001); I.R.S. Priv. Ltr. Rul. 90-26-036 (June 29, 1990); I.R.S. Tech. Adv. Mem. 93-02-002 (Jan. 15, 1993).
172. Estate of Kite v. Comm'r, 105 T.C.M. (CCH) 1277 (2013).
173. *See id.*
174. *See id.*
175. *See id.*
176. *See id.*
177. *See id.*
178. *See id.*; I.R.C. § 2519 (2012).

in a footnote, the tax court provided that all of the assets in the marital trusts, including the appreciated assets gifted to him shortly before death, received a step-up in basis under section 1014.[179] The decision and the result of the case (in particular with respect to section 1014(e)) have been criticized by a number of commentators.[180]

C. Community Property and Elective/Consensual Community Property

The Code provides a special rule for community property.[181] Section 1014(b)(6) provides that "property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate" shall be deemed to have been acquired from or to have passed from the decedent.[182]

There are currently nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.[183] Two states are separate property states but they allow couples to convert or elect to treat their property as community property: Alaska and Tennessee.[184] Generally, these elective or "consensual community property" laws allow residents and nonresident couples to classify property as community property by transferring the property to a qualifying trust and declaring the trust asset as community property; for nonresidents, a qualifying trust requires at least one trustee who is a resident of the state or a company authorized to act as a fiduciary of such state.[185]

Clearly, for residents of separate property states, taking advantage of the consensual community property laws of another state has the potential for a basis adjustment under section 1014(b)(6).[186] There has been no direct ruling on whether that would be the case under the laws of Alaska or Tennessee.[187]

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179. *Estate of Kite*, 105 T.C.M. (CCH) at 16 n.9 ("All of the underlying trust assets, including the OG & E stock transferred to Mr. Kite in 1995, received a step-up in basis under sec. 1014.").

180. *See* Jeff Pennell, *Jeff Pennell on Estate of Kite: Will It Fly?*, LISI Estate Planning Newsletter #2062 (Feb. 11, 2013), *available at* http://www.naepc.org/events/newsletter/4/2013; John J. Scroggin, *Understanding Section 1014(e)*, LISI Estate Planning Newsletter #2192 (Feb. 6, 2014), *available at* http://www.naepc.org/journal/issue17j.pdf.

181. *See* I.R.C. § 1014(b)(6) (2012).

182. *Id.*

183. *See Publication 555-Introductory Material*, IRS, http://www.irs.gov/publications/p555/ar01.html (last visited Jan. 12, 2015).

184. ALASKA STAT. §§ 34.77.010–.995 (2013) (Alaska Community Property Act); TENN. CODE ANN. § 35-17-101 to 108 (2010) (Tennessee Community Property Trust Act of 2010).

185. ALASKA STAT. § 34.77.060; TENN. CODE ANN. § 35-17-105.

186. *See* I.R.C. § 1014.

187. *See generally* ALASKA STAT. §§ 34.77.010–.995 (Alaska Community Property Act); TENN. CODE ANN. § 35-17-101 to 108 (Tennessee Community Property Trust Act of 2010).

However, a number of commentators have argued that assets in such consensual community property arrangements would, indeed, receive a full step-up in basis under section 1014(b)(6).[188] A professional fiduciary must be designated in Alaska or Tennessee in order to invoke the respective statutes and the administrative expense ought to be weighed against the potential benefit, taking into consideration the uncertainty.[189]

D. Establishing Community Property and Maintaining the Character

Given how valuable the full step-up in basis can be to community property under section 1014(b)(6), practitioners will need to pay special attention to methods of transmuting separate property to community property and maintaining the community property, even if the couple moves to a separate property state.[190] Married couples who move from a separate property state and establish residence in a community property state can typically transmute their separate property to community property by way of agreement.[191] For example, California provides that "married persons may by agreement or transfer, with or without consideration . . . transmute separate property of either spouse to community property."[192] As long as the couple has the intent to remain permanently in the community property state, the transmutation could occur immediately upon establishing residence in the state.[193] In other words, there is no time requirement after establishing residency when transmutation would be considered valid.[194]

Generally, if a couple moves from a community property state to a separate property state, the property will continue to maintain its community property status.[195] However, maintaining that status to maximize the benefit of section 1014(b)(6) can be a challenge.[196] For example, if community property is sold to purchase real property located in a separate property state, some courts have provided that the real property is held by the couple as

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188. Jonathan G. Blattmachr, Howard M. Zaritsky & Mark L. Ascher, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 REAL PROP. PROB. & TR. J. 615, 623–24 (Winter 1999); *see also* Comm'r v. Harmon, 323 U.S. 44 (1944) (an Oklahoma income tax case involving elective community property); McCollum v. United States, 58-2 U.S.T.C. (CCH) ¶ 9957 (N.D. Okla. 1958) (explaining what *Harmon* meant and distinguishing it in the context of basis); Rev. Rul. 77-359, 1977-2 C.B. 24.

189. *See generally* ALASKA STAT. §§ 34.77.010–.995 (Alaska Community Property Act); TENN. CODE ANN. § 35-17-101 to 108 (2010) (Tennessee Community Property Trust Act of 2010).

190. *See* I.R.C. § 1014(b)(6); *see also* Thomas M. Featherston, Jr., *His, Her, or Their Property: A Primer on Marital Property Law in the Community Property States*, BAYLOR LAW 24–25 (2014), http://www.baylor.edu/law/faculty/doc.php/205011.pdf.

191. *See* Featherston, *supra* note 190. Simply moving to a community property state typically will not automatically cause separate property to be considered community property. *See id.*

192. CAL. FAM. CODE § 850 (West 1994).

193. *See id.*; Featherston, *supra* note 190.

194. *See* FAM. § 850; Featherston, *supra* note 190.

195. *See* Featherston, *supra* note 190.

196. *See id.* at 26.

tenants in common, notwithstanding the fact that the source of the funds is community property.[197] Furthermore, if one spouse transfers assets to another spouse outright (as often happens in the estate planning process to "equalize" the estates of the spouses who now reside in a separate property state), the property is no longer considered community property.[198] Generally, income from community property and reinvestments of such income will retain its community property character.[199] Money earned while domiciled in a separate property state will remain separate property.[200] It is quite easy for commingling of funds to occur if, for example, a couple uses both community property and separate property to purchase an asset.[201] From that point forward, the couple must trace the funds and income from such funds.[202] As such, practitioners in separate property states should pay special attention to those clients who move from community property states, and practitioners should consider ways to ensure that and make clear how such property will continue to be held and reinvested.

Sixteen separate property states have enacted the Uniform Disposition of Community Property Rights at Death Act (UDCPRDA).[203] UDCPRDA provides that property that was originally community property will retain its character as such for testamentary purposes.[204] The UDCPRDA is limited in scope and is not a tax statute.[205] The law is not clear whether decedents with surviving spouses who live in a state that has enacted the UDCPRDA are in a better position to claim the step-up in basis under section 1014(b)(6) than those decedents who do not.[206]

E. Joint Revocable Trusts and the "JEST"

Following in the line of a number of rulings, a planning technique referred to as the "Joint Exempt Step-Up Trust" (JEST) has arisen that seeks to give married couples residing in noncommunity property states some of the same step-up in basis enjoyed by couples who pass away with community

197. *See id.*
198. *See id.*
199. *See id.*
200. *See id.*
201. *See id.*
202. *See id.*
203. Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Minnesota, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming. *Legislative Fact Sheet - Disposition of Community Property Rights at Death Act (1971)*, UNIFORM L. COMMISSION, http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Disposition%20of%20Community%20Property%20Rights%20at%20Death%20Act%20(1971) (last visited Oct. 31, 2014).
204. *See* UNIF. DISPOSITION OF CMTY. PROP. RIGHTS AT DEATH ACT, 8A U.L.A. 213 (2003).
205. *See id.*
206. *See id.*; *see also* I.R.C. § 1014 (2012).

property under section 1014(b)(6).[207] The attorneys who developed this technique have published the details of the JEST, including the numerous tax, creditor protection, and other legal issues surrounding the technique.[208]

The basic structure of the JEST is as follows:

(a) Married couple funds a jointly-established revocable trust, with each spouse owning a separate, equal share in the trust.[209] Either spouse may terminate the trust while both are living, in which case the trustee distributes 50% of the assets back to each spouse.[210] If there is no termination, the joint trust becomes irrevocable when the first spouse dies.[211] The first dying spouse has a general power of appointment over all trust assets.[212]

(b) Upon the first death, all assets are includible in the estate of the first to die.[213]

(c) Upon the first death, assets equal in value to the first dying spouse's unused Available Exemption Amount will be used to fund a bypass trust (Credit Shelter Trust A) for the benefit of the surviving spouse and descendants.[214] These assets will receive a step-up in basis and will escape estate tax liability upon the surviving spouse's death.[215] Any asset in excess of the funding of Credit Shelter Trust A will go into an electing qualified terminable interest property trust (QTIP Trust A) under section 2056(b)(7).[216] The assets in the QTIP Trust A receive a step-up in basis upon the first spouse's death and on the surviving spouse's death.[217]

(d) If the first dying spouse's share is less than his or her Available Exemption Amount, then the surviving spouse's share will be used to fund

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207. I.R.S. Priv. Ltr. Rul. 2001-02-021 (Jan. 12, 2001); I.R.S. Priv. Ltr. Rul. 2002-10-051 (Mar. 8, 2002); I.R.S. Priv. Ltr. Rul. 2006-04-028 (Jan. 27, 2006); I.R.S. Priv. Ltr. Rul. 2004-13-011 (Mar. 26, 2004); I.R.S. Priv. Ltr. Rul. 2004-03-094 (Jan. 16, 2004); I.R.S. Tech. Adv. Mem. 93-08-002 (Feb. 26, 1993).

208. *See* Alan S. Gassman, Christopher J. Denicolo & Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses* (pts. 1 & 2), 40 EST. PLAN. 3, 3 (Oct. 2013), 40 EST. PLAN. 14 (Nov. 2013); Alan Gassman, Tom Ellwanger & Kacie Hohnadell, *It's Just a JEST, the Joint Exempt Step-Up Trust*, LISI Estate Planning Newsletter #2086 (April 3, 2013), *available at* http://gassmanlawassociates.com/wp-content/uploads/2014/09/JEST-Article.pdf.

209. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

210. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

211. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

212. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

213. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

214. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

215. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208..

216. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

217. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

a "Credit Shelter Trust B" with assets equal to the excess exemption.[218] According to the authors of this technique, the assets of the Credit Shelter Trust B will avoid estate taxation at the surviving spouse's death, notwithstanding that the surviving spouse originally contributed the assets to the JEST and had the power to terminate the trust and reclaim the assets.[219] The authors provide that in order to further assure a step-up in basis of the assets in the Credit Shelter Trust B, it is best that the surviving spouse is not a beneficiary of Credit Shelter Trust B or perhaps is only a beneficiary that may be added by an independent trust protector in the future.[220]

(e) Any assets remaining of the surviving spouse's share in excess of what is funded into Credit Shelter Trust B will be used to fund a QTIP Trust B.[221]

The traditional concerns with this sort of planning have been whether there are one or more taxable gifts between the spouses in creating and funding the trust, and whether the desired step-up is available.[222] Definitive guidance remains scarce.

F. Section 2038 Estate Marital Trusts

Another possible method of providing a step-up in basis for all marital assets on the death of the first spouse is using what is sometimes referred to as a "Section 2038 Estate Marital Trust."[223] The basic features of a Section 2038 Estate Marital Trust are:

(a) Grantor (the Grantor Spouse) contributes assets to a trust for the benefit of his or her spouse (the Beneficiary Spouse).[224] The Grantor Spouse can be the sole trustee or co-trustee of the trust.[225] The trustee has the discretion to distribute income and principal only to the Beneficiary Spouse for such spouse's lifetime.[226] Upon the Beneficiary Spouse's death, the trust assets pass to the Beneficiary Spouse's estate.[227]

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218. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

219. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

220. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

221. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

222. *See* Gassman, Denicolo & Hohnadell, *supra* note 208; Gassman, Denicolo & Hohnadell, *supra* note 208.

223. *See* Steve R. Akers, *Hecklering Musings 2014 and Current Developments*, BESSEMER TRUST 49 (April 2014), http://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Heckerling%20Musings_February%202014_FINAL.pdf.

224. *See id.*

225. *See id.*

226. *See id.*

227. *See id.*

(b) The Grantor Spouse retains a right to terminate the trust prior to the Beneficiary Spouse's death.[228] Upon such termination, the trust assets must be distributed outright to the Beneficiary Spouse.[229]

(c) The Grantor Spouse retains the power, in a nonfiduciary capacity, to reacquire or "swap" the trust corpus by substituting other property of an equivalent value.[230]

The trust does not provide for distribution of all income annually or for the conversion of unproductive property, as would be required for a general power of appointment marital trust or QTIP Trust.[231] However, the trust should qualify for the gift tax marital deduction because the trust funds are payable only to the Beneficiary Spouse's estate, and thus the spouse's interest is not a nondeductible terminable interest under section 2523(b).[232]

The contribution of assets to the trust should be a completed gift, notwithstanding the Grantor Spouse's right to change the manner or time of enjoyment of the assets, because the only beneficiary of the trust is the Beneficiary Spouse or the estate of the Beneficiary Spouse.[233]

During the lifetime of the Beneficiary Spouse, the trust will be treated as a grantor trust for income tax purposes with respect to the Grantor Spouse under section 677(a), which provides, in pertinent part, that the "grantor shall be treated as the owner of any portion of a trust . . . whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor . . . may be distributed to . . . the grantor's spouse" or "held or accumulated for future distribution to . . . the grantor's spouse."[234] Because the Beneficiary Spouse and his or her estate is the sole beneficiary of the lifetime and the remainder interests, grantor trust treatment should be as to all of the assets in the trust and as to both income and principal.[235] Thus, no portion of the trust's income should be taxable as a nongrantor trust.[236] However, in order to ensure grantor trust status as to all of the assets and tax items of the trust, practitioners might consider having the Grantor Spouse retain the power, in a nonfiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.[237]

If the Beneficiary Spouse dies first, the trust assets will be payable to his or her estate, and thus the assets are includible in the gross estate under

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228. *See id.*

229. *See id.*

230. *See id.*

231. *See id.*; I.R.C. § 2056(b)(5)–(7)(B)(ii)(I) (2012); Treas. Reg. §§ 20.2056(b)-7(d)(2) (as amended in 2004), 20.2056(b)-5(f)(4)–(5) (as amended in 2004); Rev. Rul. 72-333, 1972-2 C.B. 530; Rev. Rul. 68-554, 1968-2 C.B. 412.

232. *See* Treas. Reg. §§ 25.2523(a)-1(b)(3) (as amended in 1995), 25.2523(b)-1 (as amended in 1994), 20.2056(c)-2(b)(1)(iii) (as amended in 1994); Rev. Rul. 72-333, 1972-2 C.B. 530.

233. *See* Treas. Reg. § 25.2511-2(d) (as amended in 1999).

234. I.R.C. § 677(a)(1)–(2) (2012).

235. *See* Treas. Reg. § 1.677(a)-1(g) (as amended in 1996).

236. *See id.*

237. I.R.C. § 675(4)(C) (2012); Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

section 2031 and are entitled to a step-up in basis.[238] If the Grantor Spouse dies first, the trust assets will be includible in the gross estate under section 2038.[239] This section provides that the gross estate will include the value of all property:

> To the extent of any interest therein of which the decedent has at any time made a transfer . . . by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death.[240]

G. The Nature of Particular Assets

1. Generally

Understanding how and to what extent assets will benefit from a step-up in basis is critical to the estate planning process. Obviously, certain assets, like highly-appreciated assets, will benefit more from the step-up in basis at death than cash (which has a basis equal to its face value which is equal to its fair market value) or property at a loss (a step-down in basis).[241] Moreover, appreciated assets, like gold, that are considered "collectibles" under the Code, benefit more from a step-up in basis than other appreciated capital assets because the federal long-term capital gain tax rate for collectibles is 28%, rather than 20%.[242]

A list of asset categories or types, starting with those that benefit the most from the step-up in basis and ending with those that benefit the least (or actually suffer a step-down in basis), might look like this:

(1) Creator-owned intellectual property (copyrights, patents, and trademarks), intangible assets, and artwork;

(2) "Negative basis" commercial real property limited partnership interests;

(3) Investor/collector-owned artwork, gold, and other collectibles;

(4) Low-basis stock or other capital asset;

(5) Roth IRA assets;

(6) High-basis stock;

(7) Cash;

(8) Passive Foreign Investment Company (PFIC) Shares;

(9) Stock or other capital asset at a loss;

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238. *See* Akers, *supra* note 223; I.R.C. § 2031 (2012).

239. *See* Akers, *supra* note 223; I.R.C. § 2038 (2012).

240. I.R.C. § 2038(a)(1).

241. *See generally id.* § 1014.

242. *Id.* § 1(h)(4).

(10) Variable annuities; and

(11) Traditional IRA and qualified plan assets.[243]

A full discussion of every asset type listed above is beyond the scope of these materials, but a number of them deserve additional consideration and discussion.[244]

2. *Creator-Owned Intellectual Property, Intangible Assets and Artwork*

a. Generally

In the hands of the creator, intellectual property, intangible assets, and artwork represent the type of asset that, from a tax standpoint, benefits greatly from the step-up in basis.[245] For the most part, during the lifetime of the creator these assets have little or no basis in the hands of the creator, and the sale, exchange, disposition, licensing, or other exploitation of these types of assets is considered ordinary income to the creator.[246] If the asset is transferred in a "carry-over" basis transaction, like a gift, the tax attributes carry to the donee.[247] On the other hand, if the creator of the asset dies with the asset, the asset is entitled to a step-up in basis, and the asset becomes a long-term capital gain asset in the hands of the beneficiaries.[248]

Patents, copyrights, and trademarks are common intangible assets, but intangible rights might also include the right of publicity—defined loosely as the right of an individual to have a monopoly on his or her own name, likeness, attributes, etc.[249] In the case of well-known artists, actors, and celebrities, this right of publicity can be quite valuable.[250] Some states, like New York, do not recognize a postmortem right to publicity, while approximately nineteen states have specifically codified the postmortem right to publicity.[251] Notably, California has codified the postmortem right to publicity, which lasts for a term of seventy years after the death of the

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243. *See id.* § 1014 (discussing how basis applies to different types of inherited property).

244. *See infra* Parts III.G.2–6.

245. *See* I.R.C. § 1221(a)(3)(A) (2012) (stating that intellectual property is not a capital asset in the hands of the creator).

246. *See id.*

247. *See id.* § 1015(a).

248. *Id.* § 1014(a).

249. Cornell University Law School, *Publicity*, LEGAL INFO. INST., http://www.law.cornell.edu/wex/publicity (last visited Nov. 8, 2014).

250. *See* Marc A. Liberstein, *Why a Reasonable Right of Publicity Should Survive Death: A Rebuttal*, BRIGHT IDEAS, Fall 2008, at 9.

251. *See* Milton H. Greene Archives, Inc. v. Marilyn Monroe LLC, 692 F.3d 983 (9th Cir. 2012), *aff'g* 568 F. Supp. 2d 1152 (C.D. Cal. 2008); *see also* RIGHT OF PUBLICITY, http://rightofpublicity.com (last visited Nov. 8, 2014) (discussing statues, cases, and current controversies; maintained by Jonathan Faber of the Indiana University McKinney School of Law).

personality.[252] Further, the California statute specifically provides that such rights are freely transferable during lifetime or at death.[253]

As one can see, each of these intangible assets has its own peculiarities (for example, the duration of the intangible rights) that may affect its value at the date of transfer—whether during lifetime or at death—and that may affect whether the asset or particular right can be transferred at all.[254]

b. Copyrights

Under U.S. law, copyright protection extends to "original words of authorship fixed in any tangible medium of expression," which includes: (1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works.[255] The courts have ruled that computer software constitutes protected literary works.[256]

Knowing the duration of an existing copyright is critical to understanding what value a copyright may have today and what value a copyright may have in the future. For works copyrighted prior to January 1, 1978, a copyright's duration is twenty-eight years, with the author (and his or her estate) having the right to renew and extend the term for another sixty-seven years (for a total of ninety-five years).[257] For works copyrighted on or after January 1, 1978, a copyright's duration is based upon the life of the author plus seventy years.[258] For works copyrighted on or after January 1, 1978, the author—or the author's surviving spouse or descendants if the author is deceased—has a right to terminate any transfer or assignment of copyright by the author thirty-five years after the transfer or assignment.[259] These termination rights apply "in the case of any work other than a work made for hire, the exclusive or nonexclusive grant of a transfer or license of copyright or of any right under a copyright, executed by the author on or after January 1, 1978, otherwise than by will."[260] Because only the author has the right of termination during his or her lifetime, even if the author gifts the copyright, the author's continued right of termination calls into question how the copyright will be valued.[261]

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252. *See* CA. CIV. CODE § 3344.1 (West 2013).
253. *See id.*
254. *See supra* Part III.G.2.a.
255. 17 U.S.C. § 102(a)(1)–(8) (2012).
256. *See*, *e.g.*, Apple Computer, Inc. v. Franklin Computer Corp., 714 F.2d 1240 (3d Cir. 1983).
257. 17 U.S.C. § 304 (2012).
258. *Id.* § 302(a).
259. *Id.* § 203(a).
260. *Id.*
261. *See id.*

Payments to the creator of a copyright for a nonexclusive license give rise to royalty income, which is taxable as ordinary income.[262] An exclusive license (use of substantially all of the seller's rights in a given medium) is treated as a sale or exchange.[263] When the creator is the seller, it is deemed to be a sale of an asset that is not a capital asset, so it is taxed at ordinary rates.[264] By contrast, if the seller is not the creator, capital asset treatment under section 1221 is available if such seller is not a dealer.[265] Notwithstanding the foregoing, if the creator/author of the copyright gifts the asset (carryover basis transaction), a sale or exchange by the donee is not afforded capital treatment either.[266] A gift for estate planning purposes, therefore, may have the unintended effect of prolonging ordinary income treatment after the death of the author/creator of the copyright.[267]

In contrast, upon the death of the author/creator who still owns the asset, the copyright is entitled to a step-up in basis to full fair market value under section 1014, and the asset is transformed into a long-term capital gain asset.[268] Because the basis of the copyright included in the creator's estate is no longer tied to that of the creator, the asset no longer falls within the exclusion from capital asset treatment under section 1221(a)(3); thus, the asset is a capital asset in the hands of the creator's beneficiaries.[269] The copyright is deemed to immediately have a long-term holding period even if it is sold within one year after the decedent's death.[270]

c. Patents

Individuals who patent qualifying inventions are granted the "right to exclude others from making, using, offering for sale, or selling" such inventions for a specified term.[271] The term for a utility or plant patent is twenty years, beginning on the earlier of the date on which the application for the patent was filed by the individual.[272] The term for a design patent is fourteen years from the date of the grant.[273]

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262. I.R.C. § 61(a)(6); *see also* Treas. Reg. § 1.61-8 (as amended in 2004); Rev. Proc. 2004-34, 2004-22 I.R.B. 991 (allowing certain taxpayers to defer to the next taxable year certain advance royalty payments).

263. *See* Wing v. Comm'r, 278 F.2d 656, 660–61 (1960).

264. I.R.C. § 1221(a)(3). Section 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have section 1221(a)(3) not apply to a sale or exchange. *See id.* § 1221(a)(3), (b)(3).

265. *Id.* § 1221. It could also be afforded section 1231 treatment (asset primarily held for sale to customers in the ordinary course of a trade or business). *See id.* § 1231.

266. *Id.* § 1221(a)(3)(C).

267. *See id.*

268. *See id.* § 1014.

269. *Id.* § 1221(a)(3).

270. *Id.* § 1223(9).

271. 35 U.S.C. § 154(a)(1).

272. *Id.* § 154(a)(2).

273. *Id.* § 173.

Similar to the taxation of copyrights, payments received for a transaction that is not considered a sale or exchange or payments received for a license will be considered royalty income, taxable as ordinary income.[274]

A sale or exchange of a patent that does not qualify under section 1235 (discussed below), may qualify for capital gain treatment because the Treasury regulations specifically provide that a patent or invention is not considered "similar property" to a copyright, which is excluded from capital gain treatment.[275] However, for the sale of a patent to qualify for capital gain treatment under section 1221, the individual generally must be considered a nonprofessional inventor (otherwise the patent would be considered stock in trade or inventory in the hands of a professional inventor).[276] Capital gain treatment under section 1231 is possible but only if the patent is considered to have been "used in [a] trade or business."[277] Often, however, patents held by individuals will not qualify as such.[278] By consequence, generally, for individuals selling or exchanging a patent, the only avenue for capital gain treatment is under section 1235.[279]

Like the tax treatment of the creator of a copyright, if the creator dies with a patent, the asset is entitled to a step-up in basis to full fair market value under section 1014, and the asset is transformed into a long-term capital gain asset.[280]

i. Section 1235 Transactions

Section 1235 provides that a "transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year."[281]

Only an individual may qualify as a holder, regardless of whether he or she is in the business of making inventions or in the business of buying and selling patents.[282] Specifically, a qualified "holder" includes (i) "any individual whose efforts created such property," or (ii) "any other individual

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274. I.R.C. § 61(a)(6); *see also* Treas. Reg. § 1.61-8 (as amended in 2004).

275. Treas. Reg. § 1.1221-1(c)(1) (as amended in 1975) ("For purposes of this subparagraph, the phrase similar property includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.").

276. I.R.C. § 1221.

277. *Id.* § 1231(a)(3)(A)(i); *see also* Kuzmick v. Comm'r, 11 T.C. 288 (1948) (stating that the holding period is deemed to start when the patent is reduced to practice).

278. *See* I.R.C. § 1231(b) (defining property used in a trade or business).

279. *See id.* § 1235.

280. *See id.* § 1014.

281. *Id.* § 1235(a).

282. *Id.* § 1235(a)(2); Treas. Reg. § 1.1235-2(d)(3) (as amended in 1980).

who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent," provided that in such instance the individual is not an employer of the creator or related to the creator.[283] As such, a trust, estate, or corporation will not qualify as a holder under section 1235, although a transfer to a grantor trust would not likely disqualify a subsequent sale or exchange to capital gain treatment.[284] An entity taxable as a partnership does not qualify as a holder, but each individual in the partnership may qualify separately as such.[285]

A sale or exchange by a qualified holder to a "related person" will not qualify for capital gain treatment under section 1235.[286] A related person is generally defined by reference to section 267(b) and includes: (i) the holder's spouse, ancestors, and lineal descendants (but not siblings);[287] (ii) a fiduciary of any trust of which the holder is the grantor; and (iii) any corporation, partnership, or other entity in which the holder, and other related persons, own 25% or more of the ownership interests.[288]

Due to the foregoing limitations on who can qualify as a holder and the related persons limitations on who can be the transferee, many estate planning techniques involving patents are limited if capital gain treatment is to be retained.

If a qualified holder sells his or her interest in a patent under section 1235 and later dies before receiving all payments, the estate or beneficiary of the deceased must report the payments as long-term capital gain as IRD.[289]

d. Artwork

The taxation of artwork in the hands of the artist is the same as it would be for the creator of a copyright, as discussed above.[290] Generally, all payments pursuant to a license and a taxable sale or exchange of the artwork give rise to ordinary income.[291] A third-party collector or investor in the

283. I.R.C. § 1235(b)(1)–(2).

284. *See* Treas. Reg. § 1.671-2(c) (as amended in 2000). If a holder sells his or her interest in a transfer qualifying under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as income in respect to a decedent. *Id.*

285. Treas. Reg. § 1.1235-2(d)(2) (as amended in 1965); *see also* I.R.S. Priv. Ltr. Rul. 2001-35-015 (Aug. 31, 2001); I.R.S. Priv. Ltr. Rul. 2002-19-017 (May 10, 2002); I.R.S. Priv. Ltr. Rul. 2002-19-019 (May 10, 2002); I.R.S. Priv. Ltr. Rul. 2002-19-020 (May 10, 2002); I.R.S. Priv. Ltr. Rul. 2002-19-021 (May 10, 2002); I.R.S. Priv. Ltr. Rul. 2002-19-026 (May 10, 2002); I.R.S. Priv. Ltr. Rul. 2005-06-008 (Feb. 11, 2005); I.R.S. Priv. Ltr. Rul. 2005-06-009 (Feb. 11, 2005); I.R.S. Priv. Ltr. Rul. 2005-06-019 (Feb. 11, 2005).

286. I.R.C. § 1235(d).

287. *Id.* § 1235(d)(2).

288. *Id.* § 1235(d)(1).

289. *Id.* § 691; Treas. Reg. § 1.691(a)-3 (as amended in 1980).

290. *See supra* Part G.

291. I.R.C. §§ 1221(a)(3), 61(a)(6). Section 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have section 1221(a)(3) not apply to a sale or exchange.

artwork might qualify for capital gain treatment or section 1231 treatment, as long as the property is not held out for sale in the ordinary course of a trade or business.[292] Similarly, capital gain treatment is not available to a donee of the artist because the donee's basis is determined by reference to the artist's basis.[293]

Artwork in the hands of a collector or investor—third party other than the creator or a donee of the creator—is considered a collectible under the Code and would be subject to the 28% long-term capital gain tax, rather than the 20% tax.[294] Under the Code, a "collectible" is any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other tangible personal property designated by the IRS as such.[295]

As with copyrights and patents, the basis of property in the hands of a person who acquired property from a deceased artist is the fair market value of the property at the date of the artist's death or on the alternate valuation date, if so elected.[296] The artwork in the hands of the estate or the artist's beneficiaries becomes a capital asset, qualifying for long-term capital gain treatment.[297]

3. *"Negative Basis" Assets and "Negative Capital Account" Partnership Interests*

"Negative basis" is the colloquial phrase used to describe a situation where the liabilities in a partnership, as also shared by the partners, are in excess of the tax basis of the partnership assets (and in the basis of the partners' interests in the partnership).[298] Note, the basis of an asset may not go below zero, so the phrase negative basis is technically incorrect.[299] Even successful real property investment partnerships may have negative basis assets where the underlying developed real property has been fully depreciated and cash from refinancing has been distributed to the owners or partners.[300]

The following example illustrates how this negative basis problem can arise and how costly a taxable event is from an income tax standpoint:

Taxpayer buys an office building in 1983 for $10 million (assume for purposes of this example, the entire purchase price is properly allocated to the office building, which is depreciable). Over the next thirty years, the property appreciates in value, the taxpayer fully depreciates the original basis of $10 million in the building to zero, borrows against the property, and takes

292. *See id.* § 1221(a)(1).
293. *See id.* §§ 1221(a)(5)(B), 1015.
294. *See id.* § 1(h)(4).
295. *See id.* §§ 1(h)(5)(A), 408(m)(2).
296. *See id.* § 1014(a).
297. *See id.* §§ 1221(a)(3), 1223(9).
298. *See id.* § 705.
299. *See id.* § 705(a)(2).
300. *See id.* § 705.

the loaned funds tax free.[301] As a result, in 2014, the office building is now worth $20 million, has zero adjusted tax basis, and has a mortgage on the building of $15 million ($5 million of net equity in the property).[302]

Note, because the property was placed in service in 1983, an accelerated method of depreciation was allowable on the property.[303] As such, a taxable sale of the property will be subject to recapture under the Code.[304] Because the property was placed in service prior to 1986, recapture is under section 1245, rather than section 1250, which generally applies to real property.[305] As such, the total amount of the depreciation deductions is subject to recapture as ordinary income.[306]

If the building is sold for $20 million in a taxable transaction, the gain would break down as follows:

Amount Recognized:	$20,000,000
Adjusted Basis:	$ -------
Recapture:	$10,000,000 ordinary income
Long-Term Capital Gain:	$10,000,000 long-term capital gain

Assuming the taxpayer is in the highest income tax bracket and in a relatively high income tax state, like a New York City taxpayer, the ordinary rate would be approximately 45% and the long-term capital gain rate would be approximately 37%.[307] The total tax liability would be $8.2 million.[308]

301. *Id.* §§ 1016(a)(2), 168(a); Treas. Reg. § 1.1016-3(a)(1)(i) (as amended in 2014).

302. *See* I.R.C. § 1016(a).

303. *See generally* Economic Recovery Tax Act of 1982, Pub. L. No. 97-248, 95 Stat. 172 (1981) (ERTA); Tax Equity and Fiscal Responsibility Act of 1984, Pub. L. No. 97-248, 96 Stat. 324 (1982) (TEFRA); Deficit Reductions Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984); Amendment to the Internal Revenue Code of 1954 § 103, Pub. L. No. 99-121, 99 Stat. 505 (1985); Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (TRA 1986). The Accelerated Cost Recovery System (ACRS) was enacted in 1981 under ERTA. ACRS was later modified by TEFRA and the Tax Reform Act of 1984, when the recovery period for most real property was extended from 15 to 18 years. In 1985, the real property recover period was extended from 18 to 19 years. ACRS generally applies to property placed in service after December 31, 1980, and before December 31, 1986. *See* Prop. Treas. Reg. § 1.168-4(a). TRA 1986 dramatically changed the applicability of ACRS to real property investments and instituted the modified ACRS (MACRS). Notably, the "applicable recovery period" for most real property assets like buildings are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods. I.R.C. § 168(c). In this example, because it was placed in service before 1984, the building would be considered 15-year real property, pursuant to which the applicable percentage of depreciation was 12% in the first year, reducing to 5% in from 11 to 15 years.

304. I.R.C. § 1245 (2012).

305. *Id.* § 1245(a)(5). Section 1245(a)(5), before being amended by TRA 1986, defines "§ 1245 recovery property" to include all recovery property under ACRS (real or personal) other than certain types of 19 year (18 year for property placed in service after March 15, 1984, and before May 9, 1985, and 15 year for property placed in service before March 16, 1984) real property and low-income housing, residential rental property, property used "predominantly" outside the United States, property as to which an election to use straight-line recovery is in effect, and certain low-income and federally insured residential property. *See id.* § 1245. The foregoing types of property are subject to recapture under section 1250. *See id.* § 1250. In this example, the office building does not fall within the listed categories, and as such is subject to recapture under section 1245. *See id.* §§ 1245, 1250.

306. *See id.* § 1245(a)(2).

307. *See id.* § 1; N.Y. TAX LAW § 601 (McKinney 2013).

308. *See* I.R.C. § 1; N.Y. TAX LAW § 601.

After repayment of the $15 million of debt, the taxpayer (who would net $5 million in cash from the transaction before taxes) would actually have a deficit of approximately -$3.2 million after the payment of income taxes.[309]

Compare this with the result in a situation where the taxpayer died owning the building (assume for simplicity's sake, the building no longer has a mortgage).[310] The building would get a step-up in basis under section 1014(a) to fair market value, and the recapture and long-term capital gain tax problem would be eliminated.[311] If the taxpayer has $5.34 million of Applicable Exclusion Amount available, the maximum estate tax liability (assuming a maximum state death tax rate of 16% and state death tax exemption equal to the federal exclusion amount) is approximately $7.3 million (maximum blended rate of 49.6%).[312] If the Applicable Exclusion Amount grows to $8 million, for example, then the estate tax liability falls to a bit less than $6 million.[313] If the foregoing building was in California, the income tax liability would be greater, and the estate tax cost would be even less because California does not have a death tax.[314] With an Applicable Exclusion Amount of $5.34 million, the estate tax liability is less than $5.9 million.[315]

Property placed in service after 1986 will not have as egregious of an income tax problem because the gain would not have recapture calculated under section 1245.[316] Rather, section 1250 would be the applicable recapture provision.[317] "Section 1250 property" means any real property, with certain exceptions that are not applicable, that is or has been property of a character subject to the allowance for depreciation.[318] Section 1250(a)(1)(A) provides that if section 1250 property is disposed of, the "applicable percentage" of the lower of the "additional depreciation" in respect of the property or the gain realized with respect to the disposition of the property shall be treated as ordinary income.[319] In short, section 1250 provides that all or part of any depreciation deduction in excess of straight-line depreciation is recaptured as ordinary income.[320] Under the current depreciation system, straight-line deprecation is required for all residential rental and nonresidential real property.[321] As such, section 1250 recapture is typically not a problem for property placed in service after 1986.[322] The Code does, however, tax

309. *See* I.R.C. § 1; N.Y. TAX LAW § 601.
310. *See* I.R.C. §§ 1014, 1245.
311. *See id.* §§ 1014, 1245.
312. *See id.* § 1014.
313. *See id.*
314. *See* CAL. REV. & TAX CODE § 17041 (West 2013).
315. *See id.*
316. *See* I.R.C. § 1245.
317. *See id.* § 1250.
318. *Id.* §§ 1245(a)(3), 1250(c).
319. *Id.* § 1250(a)(1)(A).
320. *Id.* § 1250(b)(1), (3), (5).
321. *Id.* § 168(b)(3)(A)–(B).
322. *See id.* § 1250.

"unrecaptured section 1250 gain" at a 25% tax rate.[323] 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.[324]

From an estate planning perspective, it is important to remember that even if recapture is inherent in an appreciated property, it does not apply to a disposition by gift or to a transfer at death, unless the recapture would be considered income in respect to a decedent.[325]

Today, most real property investments are not held individually, but are held typically in an entity taxable as a partnership (for example, a limited liability company or limited partnership). When real property investments are subject to refinancing followed by a distribution of the loan proceeds, the partnership debt rules under section 752 must be considered when determining the income tax cost of selling such property.[326] Any increase in a partner's share of partnership liabilities (whether recourse or nonrecourse to such partner) is treated as a contribution of money by the partner to the partnership, resulting in an increase in the partner's basis in his or her partnership interest (outside basis).[327] Any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner, resulting in a decrease in the partner's outside basis.[328] A partner's outside basis may not be reduced below zero, so a deemed distribution of money that arises from a decrease in a partner's share of liabilities will give rise to gain recognition.[329]

In the example described above, consider a situation where a partnership owned a fully depreciated $20 million building. The partnership has $15 million of debt, which is in excess of the basis in the building and in excess of the taxpayer's outside basis. Assume for this example that we can ignore other partners because they have relatively insubstantial interests in the partnership. When a partner has a negative capital account so that the outside basis is less than the partner's share of partnership liabilities, it is also colloquially called negative basis.[330] As discussed above, this is a misnomer because basis can never go below zero.[331] A transfer by the taxpayer, whether a taxable sale or a gift to a nongrantor trust, creates what is often referred to as "phantom gain" because the transferee takes over the transferor partner's negative capital

323. *See id.*
324. *Id.* § 1(h)(6).
325. *Id.* § 1250(d)(1)–(2).
326. *See id.* § 752.
327. *See id.* §§ 752(a), 722; Treas. Reg. § 1.752-1(b) (as amended in 2005).
328. *See* I.R.C. §§ 752(b), 733; Treas. Reg. § 1.752-1(c).
329. *See* I.R.C. §§ 731(a), 751.
330. *See generally* Carter G. Bishop, *A Tale of Two Liabilities,* 16 WM. MITCHELL L. REV. 1 (1990).
331. *See id.* Partnership borrowings and payments of liabilities do not affect the capital accounts because the asset and liability changes offset each other. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(c) (as amended in 2013).

account.[332] It should also be noted that a partner who sells his or her partnership interest must include in income his or her allocable share of the partnership's recapture from depreciated partnership property.[333] The transfer results in a decrease in the transferor partner's share of liabilities, which in turn is treated as a distribution of money to the partner when the partner has an outside basis of zero, resulting in a gain in a donative transfer or additional gain in the case of a taxable sale.[334]

When dealing with highly appreciated, depreciable assets like real property and partnership debt, taxable sales of the property and *inter vivos* transfers of partnership interests can be problematic.[335] In many cases, given reduced transfer tax rates and growing Applicable Exclusion Amounts, it will make more economic sense to die owning these assets than to transfer them during the partner's lifetime.[336] The transfer of a partner's interest on death is a disposition that does not result in gain or loss recognition, even if the liability share exceeds outside basis.[337] The outside basis of the decedent receives a step-up in basis to fair market value (net of liabilities) but is also increased by the estate's share of partnership liabilities.[338] Further, if the partnership makes an election under section 754, the underlying assets in the partnership will also receive a step-up in basis.[339]

Even if a section 754 election is not made, the estate or the successor beneficiaries of the partnership interest can get the benefit of a step-up in the underlying assets if the successor partner makes an election under section 732(d) and the partnership distributes the assets for which there would have been a basis adjustment.[340] 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.[341]

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332. *See* Brendan Smith, *Sidestepping Partnership Phantom Gain Based on Restructuring Nonrecourse Debt*, 18 J. REAL EST. TAX'N 142 (Winter 1991).

333. I.R.C. §§ 751, 453(i)(2) (2012). Under section 751, unrealized receivables are deemed to include recapture property, but only to the extent the unrealized gain is ordinary income. Treas. Reg. § 1.751-1(e), (g) (as amended in 2004).

334. *See* Rev. Rul. 84-53, 1984-1 C.B. 159, situation 4.

335. *See* Steve Breitstone & Jerome M. Hesch, *Income Tax Planning and Estate Planning for Negative Capital Accounts: The Entity Freeze Solution*, 53 TAX MGMT. MEMO. 311 (Aug. 13, 2012).

336. *See id.*

337. *See* Elliott Manning & Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 TAX MGMT. REAL EST. J. 263, 272 (1995); Louis A. del Cotto & Kenneth A. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 TAX L. REV. 569 (1979).

338. I.R.C. §§ 1014(a)–(b), 742 (2012); Treas. Reg. §§ 1.1014-1(a)–(b) (as amended in 1973), 1.742-1 (1960). The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3) (as amended in 2004).

339. I.R.C. § 743(a) (2012).

340. I.R.C. § 732(d); Treas. Reg. § 1.732-1(d)(1)(i)–(iii) (as amended in 2004).

341. Treas. Reg. § 1.732-1(d)(2).

4. Traditional IRA and Qualified Retirement Assets

In 2013, the Investment Company Institute estimated that total retirement assets were over $20 trillion (including government plans, private defined benefit plans, defined contribution plans, and individual retirement accounts).[342] Assets in IRAs and defined contribution plans combined to produce more than half of the total, at approximately $11.1 trillion.[343] Although IRA and qualified retirement assets make up one of the largest asset types owned by individuals, they are one of the most problematic from an estate planning perspective.[344]

IRA and qualified retirement assets are not transferable during the lifetime of the owner, so the assets are never candidates for lifetime gifts, unless the owner is willing to incur a taxable distribution of the assets.[345] As such, to the extent not drawn down prior to death, the assets are includible in the estate for transfer tax purposes, and by definition, the assets will use some or all of the decedent's Applicable Exclusion Amount, unless the assets are transferred to a surviving spouse under the marital deduction of section 2056 or to a charitable organization under section 2055.[346] To make things worse, IRA and qualified retirement assets are considered income in respect to a decedent (IRD) under section 691.[347]

IRD assets are not entitled to a step-up in basis, and all distributions—whether paid over time or not—to a beneficiary are taxable as ordinary income.[348] Even though the beneficiary is entitled to an income tax deduction[349] (IRD deduction) for estate taxes payable by virtue of the inclusion of the assets, there is no federal income tax deduction for state death taxes that might be payable, and given the reduced federal transfer tax rate of 40% and the cost-of-living increase on the Applicable Exclusion Amount, many taxpayers will have very little or no IRD deduction to shelter the on-going ordinary income tax problem.[350]

A distribution from a decedent's IRA to a surviving spouse may be "rolled over" to another qualified retirement plan or IRA, thereby deferring

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342. *See Defined Contribution Plan Participants' Activities, First Three Quarters of 2013*, INVESTMENT COMPANY INST. (Feb. 2014), http://www.ici.org/pdf/ppr_13_rec_survey_q3.pdf.

343. *See id.*

344. *See id.*

345. *See* I.R.C. § 401(a)(13)(A) (2012) (establishing an anti-alienation provision).

346. *Id.* § 2039(a). The IRS has taken the position that qualified retirement assets used to fund a pecuniary bequest to a charitable organization will be considered an income recognition event, triggering ordinary income. I.R.S. Chief Counsel Advisory 2006-44-020 (Nov. 3, 2006).

347. *See, e.g.*, Ballard v. Comm'r, 63 T.C.M. (CCH) 2748 (1992); Hess v. Comm'r, 271 F.2d 104, 106 (3d Cir. 1959); Rev. Rul. 92-47, 1992-1 C.B. 198; Rev. Rul. 69-297, 1969-1 C.B. 131; I.R.S. Priv. Ltr. Rul. 91-32-021 (Aug. 9, 1991); I.R.S. Gen. Couns. Mem. 39,858 (Sept. 9, 1991).

348. I.R.C. §§ 61(a)(14), 72, 402(a), 408(d)(1), 1014(c) (assuming the decedent owner had no nondeductible contributions).

349. *See id.* § 691(c)(1).

350. *See id.*

the recognition of income.[351] In addition, if the surviving spouse is the beneficiary of all or a portion of the decedent's IRA, the surviving spouse may also elect to treat the decedent's IRA as his or her own IRA.[352] In both of the foregoing cases, the IRD problem discussed above continues after the death of the surviving spouse (unless the surviving spouse remarries).[353] Because of the income tax liability built-in to retirement plans and IRAs, they should be among the first assets considered for clients who intend to benefit a charity at death.[354] Many techniques are available beyond outright charitable gifts including, for example, testamentary funding of a charitable remainder trust.[355]

Contrast the foregoing treatment with a Roth Individual Retirement Plan (Roth IRA).[356] Roth IRA assets are treated similarly to assets in a traditional IRA in that: (i) the account itself is not subject to income tax; (ii) distributions to designated beneficiaries are subject to essentially the same required minimum distribution rules after the death of the original Roth IRA owner; and (iii) surviving spouses may treat a Roth IRA as their own and from that date forward the Roth IRA will be treated as if it were established for the benefit of the surviving spouse.[357] In contrast to a traditional IRA, distributions to a qualified beneficiary are not taxable to the beneficiary and, as discussed above, are not subject to the Medicare tax.[358] The overall result for decedents with Roth IRA assets is that the qualified beneficiaries of the Roth IRA effectively receive the benefit of a step-up in basis. Since 2010, all taxpayers, regardless of adjusted gross income, can convert traditional a IRA assets into a Roth IRA.[359] The conversion is considered a taxable event causing the converted amount to be includible in gross income and taxable at ordinary income tax rates.[360] Taxpayers can also make direct taxable rollovers from qualified company-based retirement accounts (section 401(k), profit sharing, section 403(b), and section 457 plans) into a Roth IRA.[361] Individuals who have excess qualified retirement assets, have sufficient funds to pay the resulting tax liability from outside of the retirement account, and who are not planning to donate the asset to a charitable organization should consider a Roth

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351. *See id.* § 402(c)(9).
352. *See* Treas. Reg. § 1.408-8, Q&A-5(a) (as amended in 2014).
353. *See* I.R.C. § 402(c)(9); Treas. Reg. § 1.408-8, Q&A-5(a).
354. *See* I.R.C. § 402(c)(9); Treas. Reg. § 1.408-8, Q&A-5(a).
355. *See* Treas. Reg. § 1.408-8, Q&A-5(a).
356. I.R.C. § 408A (2012).
357. *See* Treas. Reg. §§ 1.408A-1, Q&A-1(b), 1.408A-6, Q&A-14, 1.408A-2, Q&A-4.
358. I.R.C. §§ 408A(d)(1), 1411(c)(5).
359. *See generally* Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345 (2006) (effective for tax years beginning after December 31, 2009). Prior to this change, only taxpayers having less than $100,000 in modified adjusted gross income could convert a Traditional IRA to a Roth IRA.
360. I.R.C. § 408A(d)(3)(A)(i).
361. *See id.*; I.R.S. Notice 2008-30, 2008-12 I.R.B. 638 (Mar. 24, 2008); I.R.S. Notice 2009-75, 2009-39 I.R.B. 436 (Sept. 28, 2009).

IRA conversion.[362] Notwithstanding the clear benefits of passing the Roth IRA assets to children and grandchildren outside of the scope of the IRD provisions, not many individuals are willing to pay the income tax cost of the conversion.[363]

5. Passive Foreign Investment Company (PFIC) Shares

A PFIC is a foreign corporation in which 75% or more of the gross is "passive" or the average percentage of assets that produce passive income is at least 50%.[364] The PFIC rules do not apply to any U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation.[365] The PFIC rules generally provide that when a U.S. shareholder receives a distribution from a PFIC then a special tax regime applies, rather than treating them under the normal rules of U.S. taxation (e.g., dividend treatment).[366] Under the PFIC tax regime, distributions from a PFIC will be treated either as "excess" or "nonexcess" distributions.[367]

An excess distribution is any portion that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder's shares within the three preceding years (or shorter if the shareholder has held the shares for less than three years).[368] All other distributions, or portions thereof, are treated as nonexcess distributions.[369] With respect to nonexcess distributions, the normal rules of U.S. taxation apply, which generally results in dividend treatment.[370] However, the dividend will not be considered a qualified dividend taxable at 20% because a PFIC will never be a "qualified foreign corporation."[371]

The portion of any distribution that is considered an excess distribution will first be allocated to each day in the shareholder's holding period for the shares.[372] Any portion so allocated to the current year and the non-PFIC years will be included in the year of receipt as ordinary income (not qualified dividends).[373] The portion of the excess distribution that is allocated to other years (the "PFIC years") is not included in the shareholders income

362. *See* I.R.C. § 408A(d).

363. *See Estimated Taxes and Roth IRA Conversions*, ROTH IRA (Apr. 25, 2011), http://www.rothira.com/blog/estimated-taxes-and-roth-ira-conversions.

364. I.R.C. § 1297(a)(1)–(2) (2012). " Generally, 'passive income' . . . is foreign personal holding company income, as provided in § 954(c)." *Id.* § 1297(b).

365. *Id.* § 1297(e).

366. *See id.* § 1297.

367. M. Read Moore, *Indirect Ownership of CFC and PFIC Shares by U.S. Beneficiaries of Foreign Trusts*, 108 J. TAX'N 105, 110 (2008).

368. I.R.C. § 1291(b)(2)(A) (2012).

369. *See* Moore, *supra* note 367.

370. Prop. Treas. Reg. § 1.1291-2(e)(1); 57 Fed. Reg. 11024-01, 11032 (Apr. 1, 1992).

371. *See* I.R.C. § 1(h)(11)(C)(iii) (2012).

372. *Id.* § 1291(a)(1)(A).

373. *Id.* § 1291(a)(1)(B).

but is subject to a "deferred tax."[374] The deferred tax is added to the tax that is otherwise due. In computing the deferred tax the shareholder multiplies the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year.[375] The shareholder then adds all of the "unpaid" tax amounts for all of the PFIC years, and then computes interest on those unpaid tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal underpayment rate.[376] The deferred tax and interest are separate line items on the individual shareholder's income tax return.[377]

The sale of PFIC shares is considered excess distributions to the extent the consideration for the sale is in excess of the shareholder's tax basis in the PFIC shares.[378] Thus, effectively the gain is treated as ordinary income, which is treated as realized ratably over the seller's holding period for purposes of determining the deferred tax and interest for prior years.[379]

U.S. shareholders of a PFIC may make a "qualified elective fund" (QEF) election to avoid the excess distribution regime.[380] If the shareholder makes a QEF election, the shareholder must include in gross income a pro rata share of the PFIC's ordinary income and net capital gain each taxable year.[381] If a shareholder makes this election, he or she must have access to the PFIC's books and records so the allocable share of the PFIC's income and gain can be calculated.[382]

The death of a U.S. shareholder is not a taxable disposition of the PFIC shares if the death results in a transfer to a domestic U.S. estate or directly to another U.S. taxpayer.[383] By contrast, a transfer upon the death of a U.S. shareholder to a testamentary trust or to a foreign person will be considered a taxable disposition.[384] The proposed treasury regulations treat a transfer upon death as a transfer by the shareholder immediately prior to death and thus reportable in the decedent's last tax return.[385] If the PFIC shares are held in a grantor trust, the grantor's death is a taxable disposition unless one of the exceptions applies.[386]

PFIC shares are nominally eligible for a step-up in basis. However, section 1291(e)(1) provides that a succeeding shareholder's basis in PFIC shares is the fair market value of the shares on the date of death but then

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374. *Id.* § 1291(c).
375. *Id.* § 1291(c)(1).
376. *Id.* § 1291(c)(1), (2), (3).
377. *Id.* § 1291(a)(1)(C).
378. *Id.* § 1291(a)(2).
379. *See* Moore, *supra* note 367.
380. *See id.*
381. I.R.C. § 1293(a) (2012).
382. *See* Moore, *supra* note 367.
383. Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(A); 57 Fed. Reg. 11024-01 (Apr. 1, 1992).
384. Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(B).
385. *Id.* § 1.1291-6(d)(2).
386. *Id.* § 1.1291-6(c)(3)(iv).

reduced by the difference between the new basis under section 1014 and the decedent's adjusted basis immediately before date of death.[387] Thus, a succeeding shareholder's basis in PFIC shares received from a decedent is limited to the adjusted basis of the decedent prior to death.[388] The foregoing basis reduction rule does not apply to PFIC shares received by a succeeding U.S. shareholder upon the death of a nonresident alien decedent if the decedent was a nonresident alien during his or her entire holding period.[389]

6. Qualified Small Business Stock (QSBS)

Section 1202 provides that a portion or all of the gain from the sale or exchange of "Qualified Small Business Stock" (QSBS) will be excluded from gross income, provided the QSBS has been held for more than five years.[390] The exclusion is generally 50% of the gain.[391] The exclusion is increased to 75% for QSBS acquired after February 17, 2009, and before September 28, 2010, and to 100% for QSBS acquired after September 27, 2010, and before January 1, 2014.[392]

In addition to the gain exclusion provisions above, section 1045 allows a taxpayer who realizes gain on the sale of QSBS to rollover the gain, without gain recognition, into new QSBS within a sixty-day period beginning on the date of the sale.[393] To qualify for non-recognition, the taxpayer may not be a corporation, must have held the stock for six months at the time of the sale, and must affirmatively elect to apply section 1045. If the taxpayer so qualifies, the taxpayer will only recognize gain from the sale to the extent the amount realized on the sale of the QSBS exceeds the cost basis of any QSBS purchased during the sixty-day period, beginning on the date of sale, less any portion of the cost already used to shelter the amount realized with respect to the sale of other QSBS.[394]

Because of the gain exclusion and gain rollover aspects of QSBS, most taxpayers should seek to make *inter vivos* transfers of these assets out of their gross estates to the extent they exceed their transfer tax exclusions (both state and federal).[395] Simply put, heirs will not benefit as much from a step-up in basis because of the gain exclusion features of QSBS, and as discussed

387. I.R.C. § 1291(e)(1) (2012).
388. *See id.*
389. *Id.* § 1291(e)(2).
390. *Id.* § 1202(a)(1).
391. *Id.*
392. *Id.* § 1202(a)(3), (a)(4). There is also an exclusion of 60% with respect to QSBS of certain empowerment zone businesses. *See id.* §§ 1202(a)(2)(A), 1397C(b).
393. *Id.* § 1045(a).
394. *Id.* § 1045(a)(1).
395. *See id.* § 1045.

below, QSBS status can be retained and transferred through donative transfers to donees.[396]

QSBS is stock of a C corporation that is a Qualified Small Business (QSB) in an active business, issued after August 10, 1993 (the date section 1202 was enacted by the Revenue Reconciliation Act of 1993), and that satisfies the original issuance requirement.[397] In order to be considered a QSB, the aggregate gross assets of the corporation must not exceed $50,000,000 after August 10, 1993, before the issuance of the stock, and immediately after the issuance of the stock.[398] Only U.S. corporations can qualify for QSB status.[399]

A corporation will meet the active business requirement if the corporation uses at least 80% of its assets (measured by fair market value) in the active conduct of one or more qualified trades or businesses.[400] A qualified trade or business is any trade or business other than:

> (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, . . . brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,
>
> (B) any banking, insurance, financing, leasing, investing, or similar business,
>
> (C) any farming business . . .
>
> (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and
>
> (E) any business operating a hotel, motel, restaurant, or similar business.[401]

The original issuance requirement is met if the taxpayer acquired the stock at its original issuance for money, property, or services provided to the issuing corporation.[402] A taxpayer that receives QSBS as a gift or by death retains its character as QSBS, and the taxpayer is treated as having acquired the stock in the same manner as the transferor with a tacking of the transferor's holding period.[403] If the transfer is by death, the QSBS receives a step-up in

396. *See id.*
397. *Id.* § 1202(c).
398. *Id.* § 1202(d).
399. *Id.* § 1202(d)(1).
400. *Id.* § 1202(e). Also, the U.S. corporation may not be a DISC, a corporation for which a section 936 election is in effect, a regulated investment company, real estate investment trust, real estate mortgage investment conduit, or a cooperative. *Id.* § 1202(e)(4).
401. *Id.* § 1202(e)(3).
402. *Id.* § 1202(c)(1)(B).
403. *Id.* § 1202(h)(1), (h)(2)(A), (h)(2)(B).

basis under section 1014, but appreciation after date of death would continue to be eligible for gain exclusion under section 1202.[404]

If a partnership transfers stock to a partner, the partner is treated as having acquired the stock in the same manner as the partnership did.[405] As such, if the partnership met all of the QSBS stock eligibility requirements, the stock will be considered QSBS in the hands of the partner, and the partner's holding period will be deemed to include any time held by the partnership.[406]

As one might expect, the Code and the Treasury regulations are silent as to whether stock retains its character as QSBS if it is transferred in an installment sale to an IDGT.[407] Presumably, because the sale is ignored for income tax purposes and losing grantor trust status (whether due to death or otherwise) is akin to a donative transfer at that time, as discussed in more detail below, QSBS status passes to the IDGT.[408]

IV. MAXIMIZING AND MULTIPLYING THE "STEP-UP" IN BASIS

A. Generally

As discussed above, estate planning will focus increasingly on the income tax savings resulting from the step-up in basis.[409] Estate planners will seek to maximize the step-up in basis by ensuring that the assets that are includible in the estate of a decedent are the type of assets that will:

(a) Benefit from a step-up (avoiding the inclusion of cash or property that has a basis greater than fair market value);

(b) Benefit the most from the step-up (for example, very low basis assets, collectibles, and negative basis assets); and

(c) Provide significant income tax benefits to the beneficiaries (assets are likely to be sold in a taxable transaction after step-up or depreciable/ depletable assets giving rise to ongoing income tax deductions).

Notwithstanding these relatively simple set of goals, tax basis management can involve a large number of strategies, some of which are relatively straightforward and are broadly applicable to all clients regardless of the size of their estates. Other strategies are more complex and are only applicable to those clients with very large estates who are willing to take on such complexity, but the tax benefits can be quite significant.

In considering tax basis management in estate planning, estate planners will need to take a bifurcated approach based upon the tax nature of the assets. For clients who are likely to own primarily low basis assets that would benefit

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404. *Id.* § 1202.
405. *Id.* § 1202(h)(2)(C).
406. *Id.* § 1202(h)(1); *see also* Treas. Reg. § 1.1045-1(e)(3)(i) (as amended in 2007).
407. *See generally* I.R.C. § 1202(h)(1); *see also* Treas. Reg. § 1.1045-1(e)(3)(i).
408. *See generally* I.R.C. § 1202(h)(1); *see also* Treas. Reg. § 1.1045-1(e)(3)(i).
409. *See supra* Part IIV.

the most from a step-up in basis (e.g., creators of intellectual property or real estate developers), the estate plan will be centered around dying with the assets and benefiting from the step-up in basis.[410] To the extent the assets will be subject to federal or state transfer taxes, then consideration must be given to ensuring that estate taxes can be paid on a timely or orderly manner.[411] Thus, common features of the plan might include maintaining life insurance held by an irrevocable life insurance trust, qualifying for the payment of transfer taxes pursuant to the deferral provisions of section 6166, or securing a Graegin loan.[412] For those clients who are likely to own assets that would not likely benefit from the step-up in basis (e.g., IRA assets, actively managed publicly traded investment portfolios, or other high basis assets), then transferring the assets out of the estate would be paramount to the extent the assets would be subject to a significant federal or state transfer tax liability.[413] Finally, for those clients who have both types of assets and whose assets would be subject to a significant transfer tax liability, the strategy would involve transferring the high basis assets out of the estate through a combination of zeroed-out transfer strategies and exercising the "swap" power proactively if the assets are held in a grantor trust, as discussed later in this article.[414]

When clients are in a situation where no estate taxes will be due, referred to as a "free-base" situation, then estate planners may seek to maximize the value of certain assets because the step-up in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes). A free-base situation can arise when the assets includible in the estate are less than the decedent's remaining Applicable Exclusion Amount or a marital deduction transfer under section 2056 to the surviving spouse.[415] In these free-basing situations, practitioners will need to consider when valuation discounts are warranted and when the discounts should be removed.[416]

In addition to the foregoing, estate planners will increasingly seek to maximize the value of certain assets because the step-up in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes) and intentionally create estate tax inclusion, especially if the decedent

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410. *Tax Basis and Why It Matters*, MORGAN STANLEY, http://www.morgan stanleyfa.com/public/projectfiles/0259a883-3f09-47a5-86ff-46ad4a6a2d9d.pdf (last visited Oct. 18, 2014).

411. *See id.*

412. *See generally* Estate of Graegin v. Comm'r, 56 T.C.M. (CCH) 387 (1988); Stephanie Loomis-Price et al., *Asset Rich, Cash Poor: Addressing Illiquidity with Graegin Loans, as Well as Sections 6166 and 6161*, 36 TAX MGMT. EST. GIFTS & TR. J. 214 (July 2011).

413. *See generally* John J. Scroggin, *Tax Basis Planning - The Basics An Expanding Frontier for Tax and Estate Planning*, J. EST. PLAN. (2014), http://www.naepc.org/journal/ issue17k.pdf.

414. *See id.*

415. *See generally* I.R.C. § 2056 (2012). Another free-base situation could arise with a testamentary transfer to a zeroed-out charitable lead annuity trust. The creation of basis would significantly lower the ongoing income tax liability of the nongrantor charitable lead trust. However, increasing the value would also increase the payments to charity that are required to zero-out the testamentary transfer to the trust.

416. *See id.*

lives in a state with no state death tax and if the decedent has significant unused Available Exclusion Amount above his or her assets.[417]

B. Swapping Assets with Existing IDGTs

In 2011 and 2012, many wealthy individuals made significant taxable gifts, using all or a significant portion of their Available Exclusion Amounts, because of the risk that the exemptions would "sunset" back to 2001 levels.[418] Many of those gifts were made to IDGTs.[419]

A common power used to achieve grantor trust status for the IDGT is one described under section 675(4)(C), namely giving the grantor the power, in a nonfiduciary capacity, to reacquire the trust corpus by substituting other property of equivalent value.[420] For income tax purposes, transactions between the grantor and the IDGT will be disregarded.[421] As such, grantors may exercise the power to swap high basis assets for low basis assets without jeopardizing the estate tax includibility of the assets and without having a taxable transaction for income tax purposes.[422] To maximize the benefits of the swap power, it must be exercised as assets appreciate or are sold over time.[423] When exercised properly, this can ensure that only those assets that benefit the most from the step-up will be subject to estate inclusion.

If the grantor does not have sufficient other assets, repurchase will be difficult—although the donor could borrow cash from a third party. The income tax consequences if a note is used to repurchase property are uncertain because the trust's basis in the note may equal the grantor's original carryover basis in the asset given to the trust and now reacquired, so paying off the note may generate gain. Also, because the sudden or unexpected death of the grantor may make a repurchase difficult or impossible, estate planners may want to consider drafting "standby" purchase instruments to facilitate fast implementation of repurchase.

While the federal income tax consequences of a swap for equivalent value seem clear, practitioners should check to see whether the transaction will also be ignored for other local law purposes. By way of example, the New York Department of Taxation and Finance has ruled that an exchange of assets between a grantor and his IDGT was a sale for sales tax purposes if the assets transferred would be subject to sales tax for any unrelated taxpayers.[424]

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417. *See id.*

418. *Impact of the 2001 Act (EGTRRA)*, NAT'L PARALEGAL C., http://nationalparalegal.edu/willsTrustsEstates_Public/ FederalWealthTransferTaxes/Impactof2001Act.asp (last visited Oct. 18, 2014).

419. *See id.*

420. I.R.C. § 675(4)(C) (2012); Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

421. *See* Rev. Rul. 85-13, 1985-1 C.B. 184; I.R.S. Priv. Ltr. Rul. 95-35-026 (Sept. 1, 1995).

422. *See* I.R.C. § 675(4)(C); Rev. Rul. 2008-22, 2008-16 I.R.B. 796; Rev. Rul. 85-13, 1985-1 C.B. 184; I.R.S. Priv. Ltr. Rul. 93-35-028 (Sept. 3, 1993).

423. *See* I.R.C. § 675(4)(C); Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

424. N.Y. State Dep't of Tax'n & Fin. Advisory Op. TSB-A-14(6)S (Jan. 29, 2014).

The Obama administration has put forth a proposal that would significantly limit the ability of grantors to prospectively manage assets that would be includible in the grantor's estate through the use of this swap power.[425] Pursuant to the proposal:

> If a person who is a deemed owner under the grantor trust rules of all or a portion of a trust engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust, then the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction) will be subject to estate tax as part of the gross estate of the deemed owner, will be subject to gift tax at any time during the deemed owner's life when his or her treatment as a deemed owner of the trust is terminated, and will be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to the distributee) during the life of the deemed owner.[426]

The proposal would apply to pre-existing IDGTs because it would be effective with regard to trusts that engage in a described transaction on or after the date of enactment.[427]

C. Valuation Discounts On or Off?

A common free-base situation occurs when the first spouse passes away and assets are transferred to or for the benefit of the spouse in a transfer that qualifies for the marital deduction under section 2056.[428] In community property states, as mentioned above, the step-up in basis will also apply to the assets held by the surviving spouse.[429] Clearly, for income tax purposes, a higher valuation is preferable to a lower valuation. As such, consideration should be given to when valuation discounts should be created and when they should be removed. For example, when both spouses are alive, it is sensible to avoid valuation discounts, and if the assets that would be includible in the surviving spouse's estate are significantly above the Applicable Exclusion Amount (including any ported amount), then valuation discounts will likely save more in estate taxes than the income tax savings from the subsequent step-up at the surviving spouse's death. If a quick succession of

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425. Department of the Treasury, *Tax Provisions in Administration's FY 2015 Budget Proposals*, KPMG 166 (Mar. 2014), https://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/fy-2015-budget-booklet-toc.pdf.

426. *See id.*

427. *See id.*

428. *See* I.R.C. § 2056 (2012).

429. *See id.*

deaths is a worry, practitioners should be prepared to layer valuation discounts immediately after the first death, so postmortem estate planning might include the estate creating family limited partnerships prior to the complete settlement of the estate.

Where assets have been divided among generations to create discounts, consideration should be given to undoing those arrangements if the effect is to depress the value of an estate below the amount of the Available Exemption Amount in order to increase the income tax basis of the assets. Family limited partnerships or other entities that create valuation discounts could be dissolved or reinstated to allow the parties to the entity to withdraw for fair value or to remove restrictions on transferability.[430]

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. 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.

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.[431] 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*, 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.[432] The purpose of that agreement was to limit the marketability of each fractional interest.[433] But what might the effect on value be of an agreement that provided, instead, that any fractional owner could compel the sale of the entire asset? Similarly, a provision that allows a shareholder in business to put stock to the business at death for fair market value would seem to be outside the scope of the section.[434] In many instances, amending old agreements to include such provisions will be more likely to create gifts from the younger owners to the older owners than would terminating an old agreement and creating a new one.[435]

430. Alden Koste, *The IRS Fished Its Wish: The Ability of Section 2703 to Minimize Valuation Discounts Afforded to Family Limited Partnership Interests in Holman v Commissioner*, 59 CATH. U. L. REV. 289, 296 (2009) (discussing valuation discounts).

431. *See generally* I.R.C. § 2703 (2012).

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

433. *See id.* at 93–94.

434. *See id.*

435. *See generally* I.R.C. § 2703.

D. General Powers of Appointment

1. Generally

A general power of appointment, as defined in the Code, 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.[436] 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.[437] Moreover, the lack of knowledge of the existence of a general power of appointment will not exclude the property subject to the power from being included in the estate of the deceased power holder.[438]

From an income tax standpoint, if the power holder exercises a testamentary general power then the Code deems the property passing under the power to have passed from the deceased power holder without full and adequate consideration, and the property will get a step-up in basis.[439] If the power holder dies without exercising the testamentary general power of appointment, the property that was subject to the power is also deemed acquired from the deceased power holder, and such property will receive a step-up in basis.[440]

Given the potential income tax savings from the step-up in basis and growing Applicable Exclusion Amount in the future, estate planners will need to consider how, under what circumstances, and to what extent, a testamentary general power of appointment should be granted to future trust beneficiaries, even if the assets have been correctly transferred into a vehicle (like a dynasty trust) that is structured to avoid estate tax inclusion at every generation.[441] So-called "limited general powers" may be helpful in this respect.[442] For example, a power to appoint only to the creditors of the power holder's estate may be less susceptible to undesirable appointment than a power to appoint more broadly.[443] Further, the exercise of a power may be subject to the consent of another person so long as the person does not have a substantial interest adverse to the exercise of the power in favor of the decedent, his or her estate, his or her creditors, or the creditors of his or her estate.[444]

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436. *Id.* §§ 2041(b)(1), 2514(c).
437. *Id.* § 2041(a)(2); Treas. Reg. § 20.2041-3(b) (as amended in 1997).
438. Freeman Estate v. Comm'r, 67 T.C. 202, 207 (1976).
439. Treas. Reg. § 1.1014-2(a)(4) (1960).
440. *Id.* § 1.1014-2(b)(2).
441. *See infra* Appendix A.
442. *See* I.R.C. § 2041(b); Treas. Reg. § 20.2041-3.
443. *See* I.R.C. § 2041(b); Treas. Reg. § 20.2041-3.
444. Treas. Reg. § 20.2041-3(c)(2).

2. *Formula*

One option is to draft a testamentary general power of appointment that by formula absorbs any unused portion of a beneficiary's unused Applicable Exclusion Amount (including any DSUE Amount).[445] This would provide a step-up in basis to those assets subject to the power without causing any federal estate tax liability.[446] In theory, this formula can be drafted with great precision.[447] However, in practice, we believe it is quite difficult to draft, particularly if the drafting occurs many years from the anticipated and likely exercise (or death of the power holder), and the formula may be subject challenge by the IRS.[448]

A testamentary general power of appointment that attempts to achieve the maximum favorable tax results would seem to require the following features:

(a) A formula that determines the size or amount of the general power of appointment.[449] As mentioned above, in theory, the starting amount of the formula is the Applicable Exclusion Amount as defined in section 2010(c)(2), which includes the Basic Exclusion Amount under section 2010(c)(3)(A), which includes any increases due to the cost-of-living increase, and any DSUE Amount.[450]

(b) The starting amount would then need to be reduced by any reductions due to taxable gifts that reduced the Applicable Exclusion Amount prior to death and any testamentary transfers that would not otherwise be deductible for federal estate tax purposes (marital transfers under section 2056 and charitable transfers under section 2055).[451]

(c) Once the size of the power of appointment has been so determined, the formula would need to provide that the power is not simply exercisable against all of the assets in trust, but that it is only exercisable against those assets in the trust that would benefit the most from a step-up in basis, given the tax nature of the asset (as discussed above).[452] For example, if the trust only held publicly-traded assets, the formula would need to ensure that the power is exercisable against the lowest basis lots of securities, not against the securities that have unrealized losses or the cash.[453] The formula would likely need to determine the total income tax cost (including state income taxes) to the trust in a constructive liquidation of the assets in a taxable transaction for fair market value and then segregate those assets or portion of assets (like a separate lot of stock) that have the highest relative income tax cost compared to fair market

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445. *See* I.R.C. § 2010 (2012).
446. *See id.*
447. *See id.*
448. *See id.*
449. *See id.*
450. *See id.*
451. *See id.* §§ 2056, 2055(c).
452. *See id.* § 2010.
453. *See id.* § 2041.

value (the highest "effective" income tax cost).[454] Without this refinement, the basis adjustment under section 1014(a) will apply across all of the assets whether they benefit from the step-up in basis or not, and if the total value of the assets exceed the size of the general power of appointment, no asset will get a full step-up in basis.[455]

(d) The formula would potentially distinguish between assets that are and are not likely to be sold or redeemed in a taxable transfer (for example, closely held C corporation shares in a family-owned business) and those assets that are not likely to be sold but provide some ongoing income tax benefits by virtue of the step-up in basis (for example, depreciable and depletable assets).[456]

(e) In determining the "effective" income tax cost in a constructive liquidation of the trust assets, the formula may need to reduce the original size of the power of appointment to take into account any state death tax costs (if the beneficiary dies in a state with a state death tax) that would result from the existence of the general power of appointment.[457] Most states with a death tax have an exemption that is smaller than the federal Applicable Exclusion Amount, and no state provides for "portability" of a deceased spouse's unused state death tax exemption.[458] As such, the formula would need to take into account the effective state death tax cost (in comparison to the fair market value of the asset) and compare that to the income tax savings from the step-up in basis for the assets with the highest effective income tax cost on the date of death.[459] The formula might then reduce the size of the general power of appointment so that at the very least the effective state death tax cost equals (but likely is less than) the effective income tax cost of those assets that would be subject to the power of appointment.[460] Note, some states provide that a general power of appointment is not subject to state death tax.[461] Because of the foregoing, drafters may choose to limit the size of the general power of appointment to the lesser of the Applicable Exemption Amount and any applicable state death tax exemption.[462]

(f) To complicate things further, in determining the size of the general power of appointment, the formula will need to consider differences between the Applicable Exclusion Amount and any remaining GST exemption the beneficiary may have at the time of death.[463] For example, if the Applicable

454. *See id.*
455. *See id.* § 743. Similar to the basis adjustment under section 743 upon the death of a partner when the partnership makes or has a section 754 election. *See also* Rev. Proc. 64-19, 1964-1 C.B. 682.
456. *See supra* Part IV.D.2.
457. *See generally* I.R.C. § 2041.
458. *See infra* Appendix A.
459. *See generally* I.R.C. § 2041.
460. *See id.*
461. 72 PA. CONS. STAT. ANN. § 9111(k) (West 2013) (stating that property subject to a power of appointment is exempt from Pennsylvania inheritance tax in the estate of the donee of the power of appointment).
462. *See id.*
463. *See* Treas. Reg. § 20.2041-3(e) (as amended in 1997).

Exclusion Amount is greater than the beneficiary's GST exemption, should the general power of appointment be reduced to the lesser of the two amounts thereby foregoing some portion of the available "free" step-up in basis?[464] Or should the general power of appointment be the greater of the two amounts but provide a different disposition of those assets depending on whether the GST exemption is applied to such a "transfer" (even in the failure to exercise the power of appointment)?[465] In other words, assets receiving both a step-up in basis and application of the beneficiary's GST exemption would continue to stay in the dynasty trust, for example, and assets that only receive step-up in basis would be held in a separate "non-exempt" GST trust.[466]

Even if the formula could be so written with such precision, there is a chance that the IRS would challenge the general power of appointment (especially if the beneficiary has a surviving spouse) as indeterminable at the time of death of the beneficiary or subject to a contingency or condition precedent, and as such, the formula does not give rise to an exercisable general power of appointment.[467]

As noted above, the size of the general power of appointment should be reduced by any transfers that would not otherwise be deductible for federal estate tax purposes (marital transfers under section 2056 and charitable transfers under section 2055).[468] Whether a transfer will qualify for the marital deduction or a charitable deduction may be dependent on a QTIP election under section 2056(b)(7)(B)(v) or a qualified disclaimer under section 2518, both of which occur after the date of death.[469] A QTIP election is made on a timely filed estate tax return, and a qualified disclaimer is made nine months after date of death.[470]

The IRS may argue that despite the crux of the Fifth Circuit's ruling in *Clayton v. Commissioner*, a QTIP election relates back to the date of death and the same could be said about qualified disclaimers—these actions do not relate to a general power of appointment under section 2041.[471] The election and disclaimer do, however, affect the size of the general power of appointment.[472] As such, they are similar to a contingency that has not yet occurred on the date of death.[473]

In Private Letter Ruling 8516011, the IRS ruled that a marital bequest that was conditioned upon the surviving spouse's survival of the decedent's

464. *See id.*
465. *See id.*
466. *See id.*
467. *See id.*
468. I.R.C. §§ 2055, 2056 (2012).
469. *Id.* §§ 2055, 2056, 2518.
470. *Id.* §§ 2518(b)(2), 2056(b)(7)(B)(v).
471. Clayton v. Comm'r, 976 F.2d 1486 (5th Cir. 1992), *rev'g*, 97 T.C. 327 (1991); I.R.C. § 2518(a); Treas. Reg. § 25.2518-1(b).
472. *See Clayton*, 976 F.2d at 1487–89.
473. *See id.* at 1486.

admission to probate would not be included in the surviving spouse's estate because the spouse died prior to the will being admitted to probate.[474] In the ruling, the IRS stated that even though the spouse had the power to admit the will to probate and thus had a power of appointment, this power of appointment was subject to the formal admission to probate, which in turn requires a substantive determination by the court regarding the validity of the will.[475] As such, the general power of appointment was deemed not to exist for estate tax purposes.[476]

3. *Trust Protector*

Because of the complexities of the formula and the risk of the IRS challenging the formula, estate planners may want to rely upon an independent "trust protector" to grant or modify the terms of a limited power of appointment and expand it to a general power of appointment.[477] This has the obvious benefit of allowing the trust protector to determine the size of the testamentary power of appointment and the assets that will be subjected to the power, as the situation and the tax laws change in the future.[478]

The power would need to be granted prior to the death of the beneficiary and in writing, in all likelihood.[479] Because of the problems with relying on a formula, as discussed above, trust protectors may choose to grant a general power of appointment to each beneficiary equal to a fixed pecuniary amount based upon the beneficiary's estate situation (value of assets, existence of a surviving spouse, structure of the beneficiary's estate plan, state of domicile, etc.) and the nature of the assets in the trust (making the general power of appointment exercisable only against certain assets or portions of assets).[480] The trust protector could provide that the power of appointment will be exercisable at the death of the beneficiary, but can be revoked or modified at

474. I.R.S. Priv. Ltr. Rul. 85-16-011 (Jan. 3, 1985).

475. *See id.*

476. *See* I.R.S. Tech. Adv. Mem. 85-51-001 (Aug. 30, 1985); Kurz Estate v. Comm'r, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995).

477. *See, e.g.*, ALASKA STAT. § 13.36.370(b)(4) (2014) ("modify the terms of a power of appointment granted by the trust"); IDAHO CODE ANN. § 15-7-501(6)(c) ("To modify the terms of any power of appointment granted by the trust. However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument."); S.D. CODIFIED LAWS § 55-1B-6(3) (2014) ("Modify the terms of any power of appointment granted by the trust. However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument."); WYO. STAT. ANN. § 4-10-710(a)(xi) (West 2007) ("to grant a power of appointment to one (1) or more trust beneficiaries or to terminate or amend any power of appointment granted by the trust; however a modification, amendment, or grant of a power of appointment may not grant a beneficial interest to any person or class of persons not specifically provided for under the trust instrument or to the trust protector, the trust protector's estate or for the benefit of the creditors of the trust protector").

478. *See* I.R.C. § 2041 (2012).

479. *See id.*

480. *See id.* § 2514.

any time by the trust protector.[481] The trust protector might modify such power of appointment, for example, if the beneficiary's estate situation changed or if certain trust assets are sold.[482]

E. Forcing Estate Tax Inclusion

1. Different Strategies for Causing Estate Tax Inclusion

The first strategy would be to give someone—trustee, advisory committee, or trust protector—the discretion to grant a general power of appointment or to expand a special power of appointment so the power becomes general.[483] The individual could grant the power shortly before death if the step up in basis is desirable, given the tax rates in effect at that time (considering, of course, that when a potential power holder is "shortly before" death may not always be easy to determine).[484] Should the person with the power to grant or expand the power be a fiduciary? Should protection be given for a decision to grant or not to grant the power of appointment? Should the general power be able to be rescinded or modified by the person granting the power? Where the circumstances are clearly defined, a formula grant of a general power may be easier, and more successful, than a broadly applicable formula.[485]

The second strategy is to terminate the trust and distribute the assets to one or more beneficiaries. If a beneficiary does not have a taxable estate, then there may be no transfer tax reason to maintain the trust and there may be a negative income tax consequence to such maintenance.[486] Quite obviously, there may be nontax detriments to a beneficiary having outright ownership of such assets.[487] In such instances, transferring assets from a trust that is not includible in the beneficiary's estate into a new trust over which the beneficiary has a general power of appointment—perhaps one exercisable only with the consent of a nonadverse party to the creditors of the beneficiary's estate—may produce a step-up with minimal risk of asset diversion or dissipation.[488]

A third strategy is to include a formula in the trust agreement that would cause estate tax inclusion if appreciation is not sufficient for estate tax

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481. *See Trust Protector. The Powers and Responsibilities of a Trust Protector*, ULTRA TR., http://www.ultratrust.com/trust-protector.html (last visited Nov. 1, 2014).

482. *See id.*

483. Benjamin H. Pruett, *Tales from the Dark Side: Drafting Issues from the Fiduciary Perspective*, A.B.A. (Oct. 22, 2011), http://www.americanbar.org/content/dam/aba/events/taxation/taxiq-fall11-pruett-paperdarkside.authcheckdam.pdf.

484. *See id.*

485. *See id.*

486. *See id.*

487. *See id.*

488. Melissa Langa, *Powers of Appointment: Special GST Tax Drafting and Exercise Issues*, A.B.A. SECTION REAL PROP., TR. & EST. L. (Apr. 30, 2009), http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/symposia/2009/melissa_langa_2.authcheckdam.pdf.

benefits to outweigh income tax benefits of a step-up. For example, I make a gift of $5 million of stock with a basis of zero to a trust for my children. The trust agreement provides that on my death, if 40% of the excess of the date of death value of any asset over the date of gift value of the asset is less than 23.8% of the excess of the date of death value of the asset over the basis of the asset, the asset is distributable to my estate.[489] The formula could be written as follows: if (E)*(D-G) < (I)(D-B), asset is distributable, where E=estate tax rate, I=income tax rate, D=date of death value, G=date of gift value, and B=basis.[490] If the value of the stock is $7.5 million at my death, the stock would be distributed to my estate so that I get the income tax benefit of the step-up, which exceeds my transfer tax savings.[491] The formula creates an "estate tax inclusion period" (ETIP) so GST exemption cannot be allocated to the trust.[492]

A fourth strategy is to appoint the donor as trustee, although many trust agreements provide that the donor may never be named as trustee.[493]

The fifth strategy is to move the trust from an asset protection jurisdiction to a jurisdiction where donor's creditors can reach the assets.[494] This would also require that the donor have some beneficial interest in the trust that would cause it to be a self-settled trust.

Sixth, the estate could take the position that there was an implied agreement of retained enjoyment under section 2036(a)(1).[495] For example, donor begins living in a home gifted to the trust (perhaps pursuant to a qualified residence trust) without paying rent and takes the position that an implied agreement existed at the outset that the donor would be able to do so.[496]

The last strategy is to use a freeze partnership so that grantor's retained preferred interest gets a basis adjustment at death. Some of the pertinent components of this strategy include:

(a) Transfers cash flow and appreciation in excess of the donor's preferred return and liquidation preference.

(b) Section 754 election (discussed below) would allow a corresponding step-up to partnership's inside basis.

(c) Requires payment of a preferred return to donor, which may be difficult if yield on underlying assets is not sufficient.

(d) Preferred interest valued at zero unless an exception to section 2701 exists or if an exemption to the zero valuation rule exists (for example, a qualified payment interest).

489. *See id.*
490. *See id.*
491. *See generally* Pruett, *supra* note 483.
492. *See* I.R.C. § 2642(f) (2012).
493. *See generally id.*; Pruett, *supra* note 483.
494. *See generally* I.R.C. § 2642.
495. *Id.* § 2036.
496. *See id.*

(e) Even if the section 2701 requirements are not met and preferred interest has a zero value (e.g., because non-cumulative) so that the value of the gift equals the donor's entire interest in the partnership, at donor's death the value of preferred is includible in gross estate and there is no transfer tax on the income and appreciation to the extent it exceeds the donor's preferred return.[497]

2. Tax Consequences of Estate Tax Inclusion

One consequence is that the value of property at death is includible in gross estate. Section 2001(b) provides that adjusted taxable gifts do not include gifts that are includible in the gross estate.[498] Thus, there is a distinction between including assets in the estate of a beneficiary and including gifted assets in the estate of the donor. There is no reduction available for gifts treated as having been made by a spouse because of a split gift election, so estate tax inclusion generally should not be used for property for which a split gift election was made.

A question arises of how much is excluded from adjusted taxable gifts where less than all of the gifted property is includible in the estate (e.g., because of distributions of income or distributions of appreciation)? This question does not seem to be addressed under sections 2001, 2701, and 2702 and the Treasury regulations thereunder.[499] For example, I make a completed gift of $5 million of stock with a zero basis to a trust for my children and the stock is included in my estate as a result of one of the methods described above. During my lifetime any income and appreciation in excess of $5 million is distributed to my children free from transfer tax. On my death, the remaining $5 million of stock is includible in my gross estate and is not included in my adjusted taxable gifts. The basis in the stock will be stepped-up to the value on the date of death and the stock can be sold free from capital gains tax.

Same as the previous example except that I retain the right to receive trust income during my lifetime. My income interest does not reduce the value of the gift because it does not meet the requirements of section 2702.[500] All appreciation is distributed to my children during my lifetime. On my death, I receive a basis step-up and my adjusted taxable gifts are reduced. Under Treasury Regulation section 25.2702-6, however, my adjusted taxable gifts are only reduced by the value of my income interest and not by the full $5 million value of the stock.[501]

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497. *Id.* §§ 754, 2701.
498. *Id.* § 2001(b).
499. *Id.* §§ 2001, 2701, 2702.
500. *Id.* § 2702.
501. *See generally id.* §§ 2001, 754, 2701, 2702; Treas. Reg. § 25.2702-6 (1992).

F. *"Reverse" Estate Planning: Turning Your Poorer Parent into an Asset*

1. *Generally*

Many clients who have taxable estates also have a surviving parent or parents who lack a taxable estate.[502] A child of a parent whose taxable estate is less than the parent's Applicable Exclusion Amount may make use of the excess to save income, estate, and generation-skipping taxes if the child can transfer assets upstream, from child to parent, in such a way that the assets are included in the parent's estate with little likelihood that the parent will divert the transferred assets away from the child or child's descendants.[503]

Although the benefits of such planning have always existed, the permanent increase in the Applicable Exemption Amount recently has enhanced the benefits of such planning.[504]

2. *Estate and Generation-Skipping Tax Benefits*

To the extent a child transfers assets to an ancestor, the ancestor will include those assets in the ancestor's estate and may shelter those assets with the ancestor's estate and GST tax exemptions.[505] Transfers can be made without using the child's Applicable Exclusion Amount.[506]

Annual exclusion gifts may be made to the ancestors. The gifts may be made outright or in trust depending on the circumstances (e.g., ancestors may be given *Crummey* withdrawal rights). Discounted gifts may be made although doing so will add benefits to the transaction only if the discount is unlocked prior to the ancestor's death. The benefits of annual exclusion gifts may be significant. To illustrate, $14,000 per year for ten years at 5% equals $176,000. If the child is married and there are even two living parents, then $56,000 for ten years at 5% exceeds $700,000.[507]

The child could make adjusted taxable gifts to the ancestor. Although it may appear that such would be a wasted use of the child's gift tax exemption, if the ancestor is able to leave the given amount to child and child's descendants without estate or generation-skipping tax then the only waste would be opportunity cost to the extent that other methods could be found to transfer assets to a parent without making a gift.[508]

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502. I.R.C. § 2611 (2012).
503. *See id.*
504. *See id.*
505. Craig Janes et al., *Advanced Gift Tax Preparation Issues*, AM. INST. CERTIFIED PUB. ACCT. (Feb. 19, 2013), http://www.aicpa.org/InterestAreas/Tax/Resources/taxplanning/DownloadableDocuments/2%2019%2013%20slides%20AICPA20130219-Presentation-815448.pdf.
506. *See id.*
507. *See id.*
508. *See Upstream GRATs*, GIARMARCO, MULLINS & HORTON, P.C. (Apr. 2011), http://www.disinherit-irs.com/archive/eupdate/april2011.html.

The child may create a GRAT with a vested remainder in the ancestor. That is, the GRAT assets, after the annuity term ends, will be paid to the ancestor or to the ancestor's estate. The value of the remainder will be included in the ancestor's estate and will pass in accordance with the ancestor's estate plan.[509]

The ancestor's executor may allocate generation-skipping tax exemption to the remainder interest without regard to any ETIP under section 2642(f) because the ancestor has not made an *inter vivos* transfer of property that would be included in the estate immediately after the transfer. The amount allocated would be equal to the fair market value of the remainder interest. Where the GRAT term is ten years (or longer), and is back-weighted, the remainder value will remain a comparatively small percentage of the GRAT for the first several years of the term. Upstream GRATs will, in general, have longer terms than GRATs that are designed to transfer assets immediately to children. Commentators have speculated that a GRAT may be created with a vested interest in a child, with that child immediately transferring the remainder interest to that child's children and allocating that child's GST exemption at the time of transfer. There is no authority on whether such a transaction achieves the intended result. Private Letter Ruling 2001-07-015 ruled negatively on the assignment of a remainder interest in a charitable lead annuity trust primarily on the grounds that section 2642(e) is specifically designed to limit the ability to leverage generation-skipping tax exemption by using a charitable lead annuity trust. Here, the GRAT remainder is not being transferred at the time of its creation, but rather at its fair market value at a later time (the death of the parent owner), which is arguably not abusive.[510]

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

509. *See id.*
510. *See id.*; I.R.C. § 2642 (2012); I.R.S. Priv. Ltr. Rul. 2001-07-012 (Feb. 16, 2001).

value of the GRAT will be $975,740, with five years of payments remaining, and the value of the remainder will be about $403,000.[511]

3. Income Tax Benefits

Assets included in a parent's estate for estate tax purposes obtain a new income tax basis under section 1014(b)(9), but not if assets acquired by the parent from a child by gift within one year of the parent's death are passed back to the child or the child's spouse.[512] Suppose that the assets pay into a trust for descendants but a third party has a power of appointment to add beneficiaries to the trust?

4. Creditor Protection for Child

Assets that a parent transfers in trust to a child may be insulated from the child's creditors so long as the child's rights in the trust are properly limited.[513] The *sine qua non* is that the parent must make the transfer into the trust for state law purposes.[514]

The lapse of a *Crummey* withdrawal right may be a state law transfer, although most practitioners and trustees do not treat it as such, except in those states that provide specifically to the contrary (such as under the Uniform Trust Code).[515] A safer approach would be to have the parent exercise his or her power of appointment in favor of a new trust for the benefit of the child.[516] If the power is general then the parent should become the grantor of the trust for state law purposes.[517]

5. Limiting Parent's Ability to Divert Assets

The strategies called for require that the parent have a testamentary general power of appointment.[518] A power limited to the appointment of assets to the creditors of a parent's estate will be a general power under section 2041(b)(1).[519] If it is desirable that a parent have additional discretion then the parent could be given a power to appoint to descendants, with or without charities, and such additional powers could be conditioned on the consent of

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511. *See generally* I.R.C. § 7520 (2012).
512. *Id.* § 1014(e).
513. Alexandra Gerson et al., *Asset Protection Planning*, HELSELL FETTERMAN, http://www.helsell.com/helsell-attorney/alexandra-gerson/ (last visited Oct. 20, 2014).
514. *See id.*
515. Cindy J. Ackerman & Richard J. Kelber, *Powers of Appointment*, MOSS & BARNETT, http://www.mossandbarnettonwcco.com/documents/Powers_of_Appointment.pdf (last visited Oct. 20, 2014).
516. *See id.*
517. *See id.*
518. *See id.*
519. *See id.*; I.R.C. § 2041 (2012).

the child or others because all that is required in order to capture the tax benefits is the limited testamentary general power.[520]

If a child desires to receive an interest in the assets transferred to the parent back from the parent (e.g., parent transfers the assets into a trust for child and child's descendants, which are not available to child's creditors), then giving the parent a power that is broader than a power to appoint to the creditors of the parent's estate may be desirable.[521] For example, a parent could be given a power to appoint to parent's children and the creditors of parent's estate.[522] Child could ensure that assets were not diverted to a sibling by purchasing, from the siblings, an assignment of any rights the siblings receive in assets appointed by the parent that originated with the child.[523] The assignment would be independent of the parent but would limit the ability of a creditor (or the government) to argue that the child transferred the assets to the parent in a manner that did not give the parent any true control.[524] The ability to reach such an agreement with minors is limited.[525]

6. Parent's Creditors

A parent who has or is likely to have creditors will not be a good candidate for these sorts of transactions.[526] Creditors could include health care providers or Medicaid, tort victims (for example, if the parent is still driving), and beneficiaries of legally binding charitable pledges.[527]

In addition, by definition, a parent who is married to someone who is not also the child's parent has a potential creditor at death, although in limited instances marriage agreements coupled with state law limitations on the rights of a surviving spouse to take property over which a decedent has a testamentary general power of appointment may make these transactions feasible.[528]

7. Upstream Sale to a Power of Appointment Trust (UPSPAT)

Suppose a child creates a grantor trust, sells assets to the trust for a note, gives the child's parent a testamentary general power of appointment over the trust assets (so that the assets will be included in the parent's estate at the parent's death and receive new basis), and then the trust (which remains a grantor trust with respect to the child ever after the parent's death) uses the

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520. *See* Ackerman & Kelber, *supra* note 515.
521. *See id.*
522. *See id.*
523. *See id.*
524. *See* Treas. Reg. § 20.2041-1(c) (as amended in 1961).
525. *See id.*
526. UNIF. PROBATE CODE § 6-102 (amended 2010).
527. *See id.* § 3-805.
528. Treas. Reg. § 20.2041-1(c).

assets to pay off the note. The net effect is that the parent's net estate is increased by zero or a small amount yet the child receives a new basis.[529]

Because the contemplated transaction is not designed to remove assets from the child's estate for estate tax purposes, the issues under section 2036 that require that the grantor trust be appropriately "seeded" would not apply.[530] However, a sale to an unseeded trust could result in a note having a value less than its stated face value, thus causing the child to make a gift.[531] The parent's guarantee of the note could reduce that risk.[532]

Does the existence of the parent's general power cause the assets to be stepped-up to full fair market value, or will the value of the note reduce the amount of the step-up? Section 2053(a)(4) provides that the value to the taxable estate will be reduced by indebtedness in respect to property included in a decedent's estate.[533] The Treasury regulations provide, in relevant part:

> A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be retuned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth.[534]

Thus, the net increase to the parent's estate would seem to be zero.[535] If the parent guaranteed the obligation then this concern would be reduced.[536] Arguably, such a step is unnecessary because the regulations may be read as discretionary or optional.[537] Further, outside the trust context, the Supreme Court decision in *Crane v. Commissioner* suggests that the basis increase is

529. *See* I.R.C. § 2041 (2012).
530. *Id.* § 2036.
531. *See id.*
532. *Id.* § 2053.
533. *See id.*
534. Treas. Reg. § 20.2053-7 (as amended in 1963).
535. *See id.*
536. *See id.*
537. *See id.*

based on the fair market value of the property regardless of the associated debt.[538]

If the amount over which the parent has a testamentary general power of appointment is limited by formula to an amount that would not increase the parent's taxable estate to more than the federal estate tax exclusion, taking into consideration the parent's other assets, then a basis adjustment can be obtained for that amount because there is no need for the debt to offset the assets included in the parent's estate.[539] The trust should provide that it is for the benefit of the child's descendants, not the child, to avoid the one-year prohibition of section 1014(e), as discussed in more detail above.[540]

Might the IRS argue that payment on the note is an indirect return of assets to the child? To the extent the note is not for fair market value, that would be a direct return of assets.[541] Suppose the terms of the trust and the sale provided that no assets could be used to pay off the note beyond those required to satisfy the fair market value of the note, as determined for federal gift tax purposes.[542] The desired result would be that the amount of the child's gift would be trapped in the trust and pass other than to a child.[543]

Supposed child "sells" cash to the grantor trust for a promissory note. Section 1014(e) applies, by its terms, only to "appreciated property" acquired by the decedent by gift within one year prior to the decedent's death.[544] If the cash in the grantor trust is later swapped for the child's appreciated property then that would not be appreciated property acquired by gift.[545] The cash might have been acquired in part by gift—if the note were not valued at par—but not the appreciated property.[546] Is this extra step valuable in minimizing a challenge?

Does the death of a parent terminate the grantor trust status of the trust? If yes, that would cause the sale to be recognized by the child as of that moment, thus undoing the benefits of the transaction.[547] This is unlike a sale to a grantor trust where grantor trust status terminates because the grantor dies where, as discussed later in this article, the consensus appears to be that death cannot, or ought not, trigger a taxable transaction.[548] The Treasury regulations provide that "a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer [(defined as

538. Crane v. Comm'r, 331 U.S. 1, 11 (1947) (holding that the proper tax basis of the property acquired by bequest subject to a mortgage "is the value of the property, undiminished by mortgages thereon.").

539. *See* I.R.C. § 1014 (2012).

540. *See id.*

541. *See id.*

542. *See id.*

543. *See id.*

544. *See id.*

545. *See id.*

546. *See id.*

547. *See id.*

548. *See id.*

any transfer other than one for fair market value)] of property to a trust."[549] Section 678, by its terms, confers grantor trust status (or status that is substantially similar to grantor trust status) only in situations involving *inter vivos* general powers.[550] The IRS ruling position is that an *inter vivos* right to withdraw makes the power holder a grantor under section 678 but not replacing the true grantor, if one still exists.[551] What is the effect of parent's testamentary general power of appointment? The Treasury regulations contain two examples that are close but not directly on point:

> Example 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.
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> . . . .
>
> Example 9. 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.[552]

Note that this is the same issue that exists with respect to creating a lifetime QTIP trust that is a grantor trust with respect to the creating spouse.[553] After the beneficiary spouse dies, the property may remain in trust for the benefit of the creating spouse and the couple's descendants, becoming, essentially, a credit-shelter trust.[554] However, if the creator spouse remains the grantor of the trust for income tax purposes that will produce a substantial additional transfer tax benefit.[555]

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549. Treas. Reg. § 1.671-2(e)(1) (as amended in 2000).
550. I.R.C. § 678 (2012).
551. *See* Mesker v. United States, 261 F. Supp. 817 (E.D. Mo. 1966).
552. Treas. Reg. § 1.671-2(e)(6).
553. *See id.*
554. *See id.*
555. *See* Mitchell M. Gans, Jonathan G. Blattmachr & Diana S.C. Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP. 52 (July/Aug. 2007).

An UPSPAT may be "ready to go" to minimize the risks of delay when a parent (or ancestor) becomes ill.[556] The descendant may create the UPSPAT and transfer assets to it, retaining lifetime and testamentary powers of appointment to ensure that the gift is incomplete.[557] An instrument by which the descendant gives up those powers of appointment may be drafted as the form of a note, leaving only the date and interest rate blank.[558] Thus, on short notice, the descendant may contact the trustee, deliver the instrument surrendering the powers of appointment, and, in exchange for that gift, receive the note.[559] Obviously, a sale document could be completed at the same time if desirable.[560] Prudence suggests that the note be transferred immediately to another party to minimize the risk that the IRS will recharacterize the sale-note-payoff as a return of assets to the descendant.[561]

8. Accidentally Perfect Grantor Trust

Similar in many respects to the UPSPAT, discussed above, is a technique that practitioners have called the "Accidentally Perfect Grantor Trust" (APGT).[562] The transferor uses a parent's unused Applicable Exemption Amount and GST exemption, benefits from a step-up in basis, but still retains grantor trust status after the parent's death.[563] Pursuant to this technique, a younger generation establishes an IDGT and moves wealth into the IDGT (e.g., pursuant to an installment sale as with the UPSPAT). The terms of the IDGT provide that the parent is a beneficiary of the IDGT and is granted a testamentary general power of appointment over the IDGT's appreciated assets equal to the parent's unused Applicable Exemption Amount and GST exemption (e.g., pursuant to a formula provision, as discussed above).[564] Upon the death of the parent, the assets may be held for the benefit of the younger generation grantor and his or her descendants.[565]

In order to be successful, the APGT must avoid estate tax inclusion at the younger generation's level (under sections 2036 through 2038), cause estate

556. *See id.*
557. *See id.*
558. *See id.*
559. *See id.*
560. *See id.*
561. *See id.*
562. *See* Mickey R. Davis & Melissa J. Willms, Trust and Estate Planning in a High-Exemption World and the 3.8% "Medicare" Tax: What Estate and Trust Professionals Need to Know, Presented at The University of Texas School of Law 61st Annual Tax Conference–Estate Planning Workshop (Dec. 6, 2013), *available at* http://daviswillms.com/yahoo_site_admin/assets/docs/high_exemption_planning.364124001.pdf.
563. *See id.*
564. *See id.*
565. *See id.*

tax inclusion at the parent's passing, and provide for a step-up in basis for the estate tax includible assets.[566]

From an income tax standpoint, according to the proponents of the APGT, whether the ongoing trust will continue to be a grantor trust with respect to the younger generation or a nongrantor trust depends on whether the parent exercises the general power of appointment or allows it to lapse.[567] The Treasury regulations provide:

> If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.[568]

Thus, if the ongoing trust arises because the parent exercises the general power of appointment, then the parent is the grantor for income tax purposes, and the ongoing trust will be a nongrantor trust for income tax purposes.[569] More significantly, the argument goes, if the ongoing trust is created as a result of the failure to exercise or lapse of the general power of appointment, then the trust will continue to be a grantor trust with respect to the younger generation, who is also a potential beneficiary of such ongoing trust.[570]

In addition, to know that the grantor/beneficiary is claiming ongoing grantor trust status would challenge the IRS.[571] From an income tax reporting standpoint, prior to the death of the holder of the testamentary general power of appointment, the Form 1041 (if one believes one should, in fact, be filed) simply states the trust is a grantor trust and all tax items are being reported on the grantor's personal income tax return.[572] In the year of the power holder's death, the Form 1041 would be reported the same way with no change in taxes and with, perhaps, a disclosure that grantor trust status will continue to be claimed.[573] All of the changes to tax basis would occur on the grantor's personal income tax return.[574]

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566. *But see* I.R.S. Priv. Ltr. Rul. 2001-01-021 (Jan. 5, 2001) (discussing the applicability of section 1014(e)).
567. *See id.*; Treas. Reg. § 1.671-2(e)(5) (as amended in 2000).
568. Treas. Reg. § 1.671-2(e)(5).
569. *See id.*
570. *See id.*
571. *See* I.R.S. Form 1041 (2014).
572. *See id.*
573. *See id.*
574. *See id.*

G. Assets in IDGTs and the Installment Notes Included in the Estate

1. Generally

Notwithstanding the popularity of the estate planning technique that involves the sale of assets to an IDGT for an installment sale note, the tax ramifications of the death of the grantor when the note is still outstanding are unclear.[575] Most commentators and practitioners agree that nothing occurs for income tax purposes until grantor trust status terminates.[576]

Many would agree that if grantor trust status is terminated during the lifetime of the grantor, then a transfer is deemed to occur and the grantor may recognize gain to the extent the amount owed to the grantor exceeds the grantor's basis in the assets.[577] The IRS has ruled that when the grantor of a grantor trust that holds a partnership interest subject to liabilities renounces grant trust status, the grantor is treated as transferring the partnership interest to the trust.[578] When the interest transferred is a partnership interest and the grantor's share of the partnership liabilities is reduced, the grantor is treated as having sold the partnership interest for an amount equal to the grantor's share of the reduced liabilities.[579] The Treasury regulations also provide that if a taxpayer creates a grantor trust that purchases a partnership interest and the grantor later renounces grantor trust status, then the taxpayer is considered to have transferred the partnership interest to the trust.[580] The taxpayer's share of liabilities that are eliminated as a result of the transfer are considered part of the amount realized for income tax purposes.[581] This is one of the most problematic features of selling negative basis real property partnership interests to IDGTs.[582]

Of course, the foregoing can get quite complicated when one considers that the original assets sold to the trust may no longer be in the trust due to a swap power retained by the grantor, and the asset in the trust may have appreciated or depreciated in value, carrying both high and low tax basis at the time of the deemed transfer.[583] What is the deemed amount realized calculated against? For this reason, practitioners advise against terminating grantor trust status while the debt is still outstanding and advise clients to pay off the debt prior to the death of the grantor, if at all possible.[584]

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575. *See generally* Rev. Rul. 85-13, 1985-1 C.B. 184.
576. *See id.*
577. *See* I.R.C. § 671 (2012).
578. Rev. Rul. 77-401, 1977-2 C.B. 215.
579. *See id.* at 122.
580. Treas. Reg. § 1.1001-2 (1980).
581. *See id.* § 1.1001-2(c), ex. 5; I.R.S. Tech. Adv. Mem. 2000-11-005 (Mar. 17, 2000).
582. *See* Treas. Reg. § 1.1001–2.
583. *See id.*
584. *See id.*

There is, unfortunately, no dispositive authority on what the income tax consequences would be for the assets in the IDGT and for the outstanding installment note at the death of the grantor. It is beyond the scope of this article to discuss the intricacies of the arguments that have been posed, but there are a number of publicly available sources that will serve as better resources.[585] However, given the nature of estate planning today (maximizing the step-up in basis), some discussion of the subject is warranted.

2. Assets in IDGTs

a. Generally

Notwithstanding arguments to the contrary, the conventional view is that if the assets in the IDGT are not included in the grantor's gross estate, the trust assets will not receive a step-up in basis under section 1014.[586] Most practitioners and commentators take the position that whatever assets happen to be in the IDGT at the time of the grantor's death carry their historical tax basis.[587] Hence, swapping high basis assets with low basis assets in existing IDGTs will continue to be so important prior to the death of the grantor.[588]

One possible alternative is to view the trustee of the IDGT as having purchased the assets for the outstanding amount of the installment note at the time of the grantor's death.[589] The basis of the assets would thus be determined under section 1012.[590] However, this necessarily requires practitioners to take the position that an exchange occurs at the death of the grantor, which may give rise to adverse income tax consequences to the estate with respect to the note.[591]

b. I.R.S. Private Letter Ruling 2012-45-006

In Private Letter Ruling 201245006, the taxpayer asked the IRS how to determine the basis of property upon the death of the grantor for property owned by an irrevocable non-U.S. situs (foreign) trust.[592] The taxpayer (Taxpayer) was a foreign citizen and nonresident of the United States.[593]

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585. *See, e.g.*, Elliott Manning & 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); Jonathan G. Blattmachr, Mitchell M. Gans & 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); Ron Aucutt, *Installment Sales to Grantor Trusts*, 2 BUS. ENTITIES 28 (2002).

586. *See* Blattmachr, Gans & Jacobsen, *supra* note 585; I.R.S. Chief Counsel Advisory 2009-37-028 (Sept. 11, 2009); Treas. Reg. § 1.1014-1(a) (as amended in 1973).

587. *See* I.R.S. Chief Counsel Advisory 2009-37-028; Treas. Reg. § 1.1014-1(a).

588. *See* I.R.S. Chief Counsel Advisory 2009-37-028; Treas. Reg. § 1.1014-1(a).

589. *See* I.R.S. Chief Counsel Advisory 2009-37-028; Treas. Reg. § 1.1014-1(a).

590. *See* I.R.C. § 1012 (2012).

591. *See id.*

592. I.R.S. Priv. Ltr. Rul. 2012-45-006 (Nov. 9, 2012).

593. *See id.*

Taxpayer proposed to transfer assets to an irrevocable trust (Trust) established under the laws of Taxpayer's country (Country).[594] The assets of Trust were to include cash and stock in two companies that are publicly traded in Country and on the New York Stock Exchange.[595] The trustees of Trust are Taxpayer and X, an unrelated party (Trustees).[596] Trustees were to pay all Trust income to Taxpayer during his lifetime and could distribute principal to Taxpayer in their absolute discretion.[597] Upon Taxpayer's death, Taxpayer had a special testamentary power of appointment over the income and principal of Trust in favor of his issue.[598] If Taxpayer did not exercise his special power of appointment, Trust property would be held in further trust for the benefit of Taxpayer's issue.[599]

The IRS ruled that the foreign trust was a grantor trust for U.S. income tax purposes.[600] The IRS then ruled that the basis of the property held in trust would be the fair market value of the assets as provided under section 1014(a).[601]

Significantly, the IRS ruled that section 1014(b)(9) (requiring the property to be included in determining the value of the decedent's gross estate) was inapplicable.[602] Rather, the assets received by the grantor's issue would fall under section 1014(b)(1) (property acquired by bequest, devise, or inheritance). The IRS reasoned:

> Taxpayer's issue will acquire, by bequest, devise, or inheritance, assets from Trust at Taxpayer's death. The assets acquired from Trust are within the description of property acquired from a decedent under § 1014(b)(1). Therefore, Trust will receive a step-up in basis in Trust assets under § 1014(a) determined by the fair market value of the property on the date of Taxpayer's death. See Rev. Rul. 84-139, 1984-2 C.B. 168 (holding that foreign real property that is inherited by a U.S. citizen from a nonresident alien will receive a step-up in basis under § 1014(a)(1) and 1014(b)(1)). This rule applies to property located outside the United States, as well as to property located inside the United States.[603]

In coming to its conclusion, the IRS points out that "Section 1014(b)(9)(C) provides that § 1014(b)(9) shall not apply to property described in any other paragraph of § 1014(b)."[604] In other words, inclusion

594. *See id.*
595. *See id.*
596. *See id.*
597. *See id.*
598. *See id.*
599. *See id.*
600. *See id.*
601. *See id.*
602. *See id.*; I.R.C. § 1014 (2012).
603. I.R.S. Priv. Ltr. Rul. 2012-45-006 (Nov. 9, 2012).
604. *Id.*

in the gross estate may not necessarily be the only avenue to receive a step-up in basis.[605]

While some practitioners may seek to interpret this ruling as allowing a step-up in basis for assets in an irrevocable grantor trust not otherwise included in the gross estate of the grantor, in actuality, after discussing the matter with the attorneys who represented the taxpayer in the ruling, it appears the drafters of the ruling may have mistakenly referred to section 1014(b)(1) ("Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent") in the ruling.[606] According to the attorneys, the ruling should have referred to section 1014(b)(3), which provides for a step-up in basis for

> property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.[607]

While it is not clear in the ruling, the grantor retained the power to alter beneficial enjoyment from and after his death, not during his lifetime.[608] As such, this ruling does not stand for the proposition that assets in an IDGT can receive a step-up in basis, notwithstanding the fact that the assets are not includible in the estate of the grantor.[609]

3. *Installment Notes*

a. *Generally*

As noted above, while grantor trust exists, nothing is deemed to have occurred for income tax purposes.[610] As such, the grantor/seller in an installment sale to an IDGT effectively has no tax basis at all.[611] The concept of tax basis is moot until grantor trust status terminates, on death or otherwise.[612]

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605. *See id.*
606. *See id.*; I.R.C. § 1014.
607. I.R.C. § 1014(b)(3).
608. The drafters of the trust could not provide for a lifetime power to change beneficial enjoyment without losing foreign grantor trust status. The Code provides grantor trust status with respect to a foreign person for a portion of any trust if "the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor." *Id.* § 672(f)(2)(A)(ii).
609. *Id.* § 1014; I.R.S. Priv. Ltr. Rul. 2012-45-006.
610. *See supra* Part IV.
611. *See* Rev. Rul. 85-13, 1985-1 C.B. 184.
612. *See id.*

Except for transactions between a grantor and a grantor trust, it is well established that installment obligations are a form of IRD if the grantor/seller dies with the note outstanding.[613] Section 453B(c) provides that the general rule concerning immediate recognition of gain or loss on the subsequent transfer of an installment obligation at death is inapplicable, and the installments will be subject to the IRD rules under section 691.[614] Thus, the installment note will not be entitled to a step-up in basis.[615]

The issue of what happens with an installment obligation from an IDGT when a grantor dies has not been settled.[616] Some have argued that the installment obligation is IRD.[617] Others have argued that the installment note is not IRD, but the death of the grantor is a taxable event (as it would be if the grantor trust had been terminated during the lifetime of the grantor).[618] As such, gain is recognized on the last income tax return of the decedent in an amount equal to the outstanding debt and the basis of the assets deemed to be transferred at such time.[619] Most practitioners and many commentators believe the installment obligation is not IRD and death is not a recognition event.[620] Thus, the installment obligation is entitled to a step-up in basis under section 1014.[621]

b. Valuation

If the installment obligation is outstanding at the time of the grantor's death, the grantor's estate will include the installment obligation in the estate at its fair market value.[622] The Treasury regulations provide:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory

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613. I.R.C. § 453 (2012); Treas. Reg. § 1.453-5(a) (as amended in 1967) (defining the obligations reportable by the grantor/seller under the installment method).

614. *See* Treas. Reg. § 1.691(a)-5 (as amended in 1965).

615. *See supra* Part IV.G.1–2.

616. Henry P. Lee & Andrew R. Lee, *Oops! I Almost Forgot the Income Tax Consequences! Cancel the Call to the Malpractice Carrier!*, SD51 A.L.I.-A.B.A. 895, 903–04 (1999).

617. *See id.*

618. *See id.*

619. *See* Madorin v. Comm'r, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; Treas. Reg. § 1.1001-2(c), ex. 5–6 (1980).

620. *See* I.R.S. Chief Counsel Advisory 2009-23-024 (June 5, 2009) (after providing that a taxable event occurs when grantor trust is terminated during the lifetime of the grantor, the memorandum goes on to say, "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.").

621. *See, e.g.*, Manning & Hesch, *supra* note 585; Blattmachr, Gans & Jacobsen, *supra* note 585.

622. Treas. Reg. § 1.691(a)-5 (as amended in 1965).

> evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.[623]

The IRS has agreed that "all available data and all relevant factors affecting the fair market value must be considered" in determining the value of a promissory note, and face value is not necessarily the value to be included in the gross estate.[624]

In the past, many practitioners have claimed valuation discounts on installment note obligations included in the estate due to a number of factors, including a low interest rate, a lack of security, and the obligor's inability to pay the note as it becomes due.[625] Practitioners may want to consider whether a valuation discount should be claimed today if the obligation will be entitled to a step-up in basis to fair market value at little or no transfer tax cost (assuming there is sufficient Applicable Exemption Amount available at the time of the grantor's death).[626]

Interestingly, in transfers to a related person that trigger section 691(a)(2) (subsequent transfers of IRD assets, including a transfer to the obligor that would result in a cancellation of the indebtedness), the Code mandates that the fair market value of the obligation (and the amount that would be recognized at such time) may not be less than the face value of the obligation.[627]

c. SCINs and CCA 2013-30-033

Self-cancelling installment notes (SCINs) are used in conjunction with IDGTs to circumvent estate inclusion of the value of the note upon the death of the grantor.[628] Generally, an SCIN is a promissory note where the remaining debt is cancelled upon the death of the note holder.[629] With an SCIN, a risk premium is added as additional consideration for the death on cancellation feature.[630] The risk premium can be in the form of additional principal or

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623. *See id.* § 20.2031-4.

624. I.R.S. Tech. Adv. Mem. 82-29-001 (Feb. 1, 1982).

625. *See* M. Read Moore, *Valuation Discounts for Private Debt in Estate Administration*, 25 EST. PLAN. 195 (1998); Jerry M. Hesch, Alan S. Gassman & Christopher J. Donicolo, *Interesting Interest Questions: Interest Rates for Intra-Family Transactions*, 36 EST. GIFTS & TR. J. 128 (2011).

626. *See, e.g.*, Allen Sparkman, *Choice of Entity from an Estate Planning Perspective*, 30 COLO. LAW 73 (Oct. 2001).

627. I.R.C. §§ 691(a)(5)(B), 453(f)(1), 318(a), 267(b) (2012).

628. *See generally* Milford B. Hatcher, Jr. & Jones Day, *Freeing and Bridging the Increasing Troubled Waters of FLPs*, SM093 A.L.I.-A.B.A. 95 (2007).

629. *See generally* Gregory Widrick, *Self-Canceling Installment Notes* (S.C.I.N.): *Is It Worth It to S.C.I.N.?*, 10 CONN. PROB. L. J. 309 (1996).

630. *See id.* at 310.

additional interest.[631] The calculation of the risk premium is based on mortality tables and a discount rate (i.e., an interest rate).[632] However, there is no clear authority as to what interest rate and what mortality table an individual must use to compute the risk premium for SCINs.[633]

In Chief Counsel Advisory 2013-30-033, the chief counsel of the IRS advised that a sale of stock in exchange for installment notes and SCINs resulted in a taxable gift.[634] The situation described in the ruling involved a series of estate planning transactions including gifts to IDGTs, exchanges of assets with IDGTs, transfers to GRATs, and sales of assets to IDGTs in exchange for a series of promissory notes.[635] All of the notes provided for annual interest payments during the terms of the notes and for principal to be paid at the end of the terms.[636] Some of the notes were for a term of years based upon the decedent's life expectancy, as determined by the mortality tables under section 7520.[637] Some of the notes were SCINs that provided for a risk premium in the form of additional principal, and some were SCINs that provided for a risk premium in the form of additional interest.[638] In calculating the risk premiums, the additional principal and interest specifically were based upon the section 7520 tables, according to the ruling.[639] The taxpayer was diagnosed with a health condition shortly after the transactions and died within six months of these transactions.[640]

The IRS ruled that a deemed gift occurred because the value of the term notes and SCINs were less than the value of the stock sold in the transactions.[641] The ruling specifically asserts that the valuation tables under section 7520 do not apply to the promissory notes at question:

> We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into

631. *See id.*
632. *See id.*
633. *See id.*
634. I.R.S. Chief Counsel Advisory 2013-30-033 (July 26, 2003).
635. *See id.*
636. *See id.*
637. *See id.*; I.R.C. § 7520 (2012).
638. *See* I.R.S. Chief Counsel Advisory 2013-30-033 (July 26, 2003).
639. *See id.*; I.R.C. § 7520.
640. *See* I.R.S. Chief Counsel Advisory 2013-30-033 (July 26, 2013); I.R.C. § 7520.
641. *See* I.R.S. Chief Counsel Advisory 2013-30-033 (July 26, 2013); I.R.C. § 7520.

> consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986).[642]

This ruling seems to be one of first impression, casting doubt on the general practice of using the section 7520 mortality tables and concepts in calculating the risk premium associated with SCINs.[643] Because the last ruling requested was predicated upon no taxable gift, the IRS did not need to rule on the estate tax implications of the transactions at hand.[644] However, the ruling did note similarities to the situation described in *Musgrove vs. United States*, where the court ruled that the decedent retained an interest in the amount transferred and thus estate tax inclusion was warranted.[645]

H. The Upside of Debt

1. Generally

As mentioned above, the analysis around estate planning includes measuring the estate and inheritance tax cost (if any) of having an asset includible in the estate against the income tax savings from a step-up in basis of the asset.[646] Because the IRS measures both the estate tax liability and the adjusted tax basis at death by the fair market value of the assets, the two taxes are typically in contradistinction to each other.[647] The estate tax cost is offset, in whole or in part, by the step-up in basis.[648] The judicious use of debt or other encumbrances may allow taxpayers to reduce estate tax cost but still maintain or increase the step-up in basis.[649] Consider the following examples:

(a) Taxpayer owns an asset worth $10 million and has a $0 adjusted tax basis (for example, fully depreciated commercial real property). At the taxpayer's death, the amount includible in the gross estate for estate tax purposes under section 2031 and the new adjusted tax basis of the asset under section 1014(a) will both be $10 million.[650] Assuming no estate tax deductions, the taxable estate under section 2051 (taxable estate is determined by taking the gross estate and reducing it by the appropriate deductions) is also $10 million.[651]

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642. *See* I.R.S. Chief Counsel Advisory 2013-30-033 (July 26, 2013).
643. *See id.*; I.R.C. § 7520.
644. *See* I.R.S. Chief Counsel Advisory 2013-30-033 (July 26, 2013).
645. *See generally* Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995).
646. *See* I.R.C. § 691 (2012).
647. *See id.* § 1014.
648. *See id.* § 2001.
649. *See id.*
650. *See id.* §§ 2031, 1014.
651. *See id.* § 2051.

(b) Same as above, except prior to the taxpayer's death, the taxpayer borrows \$9 million, using the asset as collateral for the debt. Ignoring the \$9 million of cash (which would be includible in the estate) borrowed for now, at the taxpayer's death, the amount includible in the gross estate due to the asset is \$10 million, and the adjusted tax basis of the asset is also \$10 million.[652] However, the taxable estate is \$1 million because the estate is entitled to a deduction under section 2053(a)(4) "for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate."[653] Thus, the taxpayer's estate might be able to receive a full step-up in basis of \$10 million for a potential taxable estate of \$1 million, if the \$9 million of debt proceeds could be transferred out of the estate in some way.[654] If the debt proceeds remained in the estate in full, then gross estate is \$19 million (asset + debt) reduced by \$9 million of debt on the asset, resulting in a taxable estate of \$10 million.[655]

(c) Same as above, except after the loan but prior to death, the taxpayer engages in a series of "zeroed-out" transfers like GRATs or installment sales to IDGTs, with the result that only \$4 million of the original \$9 million of debt proceeds remain in the estate. The overall result, including the debt proceeds, is the asset would still receive a step-up in basis to \$10 million but the taxable estate would only be \$5 million.[656] The gross estate would be \$14 million (asset + debt proceeds) reduced by \$9 million of debt on the asset.[657]

(d) Same as above, except after the loan, instead of engaging in zeroed-out transfers, the taxpayer exchanges the \$9 million of cash from the loan with a \$9 million/\$0 tax basis asset that is in an IDGT (assets not otherwise includible in the taxpayer's estate). The overall result is both the \$10 million and \$9 million assets would receive a step-up in basis to fair market value (totaling \$19 million of basis adjustment), but the taxable estate would be \$10 million (\$19 million gross estate, reduced by \$9 million of debt).[658]

As the foregoing examples show, the key to reducing estate tax exposure and maximizing the step-up in basis is: (i) ensuring the deductibility of the debt, and (ii) engaging in an additional transaction that reduces estate tax exposure of the debt proceeds or exchanges the debt proceeds (cash) for something that would benefit from a step-up in basis.[659] Of course, one of the easiest ways to reduce the estate tax exposure on the loan proceeds is to simply spend it aggressively.[660]

652. *See generally* Crane v. Comm'r, 331 U.S. 1 (1947).
653. I.R.C. § 2053(a)(4) (2012).
654. *See id.*
655. *See id.*
656. *See id.*
657. *See generally id.* (demonstrating gross estate calculations).
658. *See id.*
659. *See id.*
660. *See generally id.* (suggesting that the estate should spend the money to avoid tax exposure).

2. Qualified Unpaid Mortgages and Indebtedness

In order to get a full estate tax deduction, the Treasury regulations state that the full value of the asset must be included in the gross estate and the indebtedness must be a liability of the estate:

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

The taxpayer may deduct the full value of the unpaid mortgage under section 2053(a)(4), even if the property is valued at less than fair market value pursuant to the special use provisions under section 2032A.[662]

The liability underlying the indebtedness must be bona fide and for adequate and full consideration.[663] As mentioned, if the liability is a charge against the property but the property is not included in the gross estate, there is no estate tax deduction.[664] As such, if a decedent only owned a one-half interest in property, the estate is not entitled to a deduction for the liability.[665] Furthermore, if the asset is real property located outside of the United States and is not includible in the gross estate, no deduction may be taken for any unpaid mortgage.[666]

The Treasury regulations make a distinction between a mortgage or indebtedness for which the estate is not liable but that only represents a charge against the property.[667] Under those circumstances, the Treasury regulations

661. Treas. Reg. § 20.2053-7 (as amended in 1963).
662. Rev. Rul. 83-81, 1983-1 C.B. 230.
663. *See* Feiberg Estate v. Comm'r, 35 T.C.M. (CCH) 1794 (1976); Bowers Estate v. Comm'r, 23 T.C. 911 (1955), *acq.*, 1955-2 C.B. 4; Hartshorne v. Comm'r, 48 T.C. 882 (1967), *acq.*, 1968-2 C.B. 2.
664. Treas. Reg. § 20.2053-7.
665. *See* Courtney Estate v. Comm'r, 62 T.C. 317 (1974); Fawcett Estate v. Comm'r, 64 T.C. 889 (1975).
666. Treas. Reg. § 20.2053-7.
667. *See id.*

provide that only the "equity of redemption" (value of the property less the debt) will be included in the gross estate.[668]

3. Debt on Assets in Trust

Given the foregoing, would the same full step-up in basis be available for assets in a trust that would be includible for estate tax purposes (or subject to a general power of appointment) if the assets were encumbered by debt? For example, consider a QTIP trust that holds a $5 million asset with an adjusted tax basis of $1 million (perhaps an *inter vivos* QTIP trust funded with a highly appreciated asset or a testamentary QTIP trust funded with a $1 million asset that appreciated significantly). The trustee of the QTIP trust borrows $3 million, using the $5 million asset as collateral for the loan, and then distributes the $3 million of loan proceeds to the surviving spouse as a principal distribution. Upon the death of the surviving spouse, does the $5 million asset in the QTIP trust receive an adjusted tax basis of $5 million (fair market value) or $2 million (the net value and the net amount taxable in the surviving spouse's estate)?

Assets held by a QTIP trust (for which a marital deduction was granted upon funding) are includible under section 2044(a), which provides "[t]he value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for."[669] For these purposes, section 2044(c) provides that for purposes of calculating the amount includible in the gross estate of the decedent, the property "shall be treated as property passing from the decedent."[670] Does the foregoing provision mean that only the net value is includible, similar to the "equity of redemption" concept of section 2053(a)(4) discussed above because the debt is not a legal obligation of the surviving spouse?[671]

The basis adjustment at death on the QTIP property is conferred by section 1014(b)(10).[672] For these purposes, it provides that "the last 3 sentences of paragraph (9) shall apply as if such property were described in the first sentence of paragraph (9)."[673] The later reference to section 1014(b)(9) is the basis adjustment at death for

> property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the

668. *Id.*
669. *See* I.R.C. § 2044(a)–(c) (2012).
670. *Id.* § 2044(c).
671. Treas. Reg. § 20.2053-7.
672. *See* I.R.C. § 1014(b)(10) (2012).
673. *See id.*

> decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code . . . .[674]

Section 1014(b)(9) provides for a reduction of tax basis for property acquired before the death of the decedent. It provides the tax basis must be "reduced by the amount allowed to the taxpayer as deductions in computing taxable income . . . for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent."[675] This is in contrast to the basis adjustment under section 1014(b)(4), which applies when a general power of appointment is exercised and does not require a similar reduction in basis.[676] That being said, section 1014(b)(9), which applies when no other paragraph of section 1014 applies, does not require any other basis reduction (for debt, by way of example).[677] As such, the basis adjustment under section 1014(a) applies, which provides the basis shall be the "fair market value of the property at the date of the decedent's death."[678]

Does this mean, in the foregoing example, the basis on the asset in the QTIP trust is $5 million because that is the fair market value of the property at the surviving spouse's death or can the fair market value of the asset mean a net value of $2 million?

V. TAX BASIS MANAGEMENT AND THE FLEXIBILITY OF PARTNERSHIPS

A. *Generally*

There are limited ways of changing the basis of an asset without having a recognition event for income tax purposes.[679] The donee of a gift generally acquires "carryover" basis increased by any federal gift tax paid attributable to any appreciation in the property transferred.[680] Moreover, if the fair market value of the gift is less than the donor's basis, the donee's basis on a subsequent sale of the property will depend on whether the sale creates a gain or a loss.[681] If the donee recognizes a loss, the donee's basis for purposes of determining the recognizable amount of such loss is the fair market value of the property at the time of the gift.[682] If the donee recognizes a gain, the donee's

674. *See id.* § 1014(b)(19).
675. *Id.*
676. *Id.* § 1014(b)(4) ("Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will.").
677. *See id.*
678. *Id.* § 1014(a)(1).
679. *See generally id.* § 1015(a) (demonstrating the limited options).
680. *Id.* § 1015(a), (d).
681. *See generally* Treas. Reg. § 1.1015-1 (as amended in 1960) (demonstrating the tax implications when the fair market value of the gift is less than the donor's basis).
682. *Id.*

basis for purposes of determining the recognizable amount of such gain is the donor's basis at the time of the gift.[683] A sale at an amount somewhere in between the basis for determining loss and the basis for determining gain results in no recognized gain or loss.[684] As discussed above, the basis of most assets will receive a step-up in basis if acquired from a decedent under section 1014(a).[685]

Estate planners should consider using entities treated as partnerships for tax purposes to proactively manage the tax basis of the assets of families.[686] The partnership rules provide sufficient planning flexibility to shift and change the basis of property through distributions (both nonliquidating and liquidating distributions) and the use of certain elections like the section 754 election.[687] For example, a partnership could distribute a high basis asset into the hands of a partner with zero outside basis.[688] The basis of the property in the hands of the partner generally would become a zero basis asset eligible for a step-up in basis on the subsequent death of the partner.[689] With a section 754 election, the "stripped" basis (i.e., the partnership's basis in the asset immediately prior to the distribution) would allow an upward basis adjustment to the other assets remaining inside the partnership.[690] Furthermore, because partnership debt can create tax basis to certain partners, the careful management of each partner's allocable share of that debt can increase or decrease basis.[691] Notwithstanding the general rules above, estate planners must consider other provisions of subchapter K, including the "mixing bowl" transaction and disguised sale rules.[692]

Understanding and proactively using the subchapter K rules concerning the basis of assets inside a partnership and the outside basis that the partners have in their partnership interests can become a valuable tax-saving tool for the estate planner.[693] In particular, estate planners should have a working knowledge of the following subjects pertaining to subchapter K and the income tax treatment of partnerships:

a. Unitary basis rules;
b. Nonliquidating "current" distributions of partnership property;
c. Liquidating distributions of partnership property;
d. Mixing bowl transactions;
e. Partnership liabilities and basis;

683. *Id.*
684. I.R.C. § 1015(a); Treas. Reg. § 1.1015-1(a)(1)–(2).
685. I.R.C. § 1014(a).
686. *See generally id.* §§ 732, 743 (demonstrating the tax benefits of partnerships).
687. *Id.*
688. *Id.* § 732(a).
689. *Id.* §§ 732(a)(2), 1014(a).
690. *Id.* § 734(b).
691. *Id.* § 752.
692. *Id.* §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, 751(b).
693. *Id.* §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, 751(b).

f. Section 754 election and inside basis adjustments;
g. Partnership divisions; and
h. Anti-abuse rules.[694]

B. Anti-Abuse Rules

In 1995, the IRS issued "anti-abuse" Treasury regulations that permit the IRS to recharacterize any transaction that involves a partnership if a principal purpose of the transaction is to "reduce . . . the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K."[695] The breadth of these provisions is potentially infinite, but they generally apply to artificial arrangements.[696] The discussion herein focuses on only those arrangements that result in changes in tax basis in light of attempting to maximize the step-up in basis.[697]

The Treasury regulations provide that the following requirements are implicit in the intent of subchapter K:

> (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.
>
> (2) The form of each partnership transaction must be respected under substance over form principles.
>
> (3) . . . the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income) . . . [or] the application of such a provision [of subchapter K] to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.[698]

The Treasury regulations take into account certain factors when determining whether a partnership formed or availed itself of "a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K."[699] Some of those factors include:

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694. *Id.* §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, 751(b).
695. Treas. Reg. § 1.701-2(b) (1995).
696. *See id.*
697. *See id*. § 1.701-2.
698. *Id.* § 1.701-2(a).
699. *Id.* § 1.701-2(c).

> (1) The present value of the partners' aggregate federal tax liability is substantially less than [it would have been] had the partners owned the partnership's assets and conducted the partnership's activities directly;
>
> (2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction . . . ;
>
> (3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss, . . . or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;
>
> (4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;
>
> . . . .
>
> (6) The benefits and burdens of ownership of property nominally contributed are in substantial part retained (directly or indirectly) by the contributing partner; or
>
> (7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed . . . .[700]

Pertinent to the concept of changing the tax basis of property, the Treasury regulations provide two examples that generally indicate that the anti-abuse provisions allow basis shifts resulting from property distributions.[701]

The first example involves a liquidating distribution of appreciated, nonmarketable securities from a partnership without a section 754 election in place.[702] The distribution resulted in a stepped-up basis in the securities. Because no section 754 election was in place, there was no downward basis adjustment by the amount of untaxed appreciation in the asset distributed.[703] The example acknowledges that the remaining partners will enjoy a timing advantage because the adjusted bases of the remaining assets did not adjust downward.[704] Further, the example provides that both the partnership and the liquidating partner had a principal purpose to take advantage of the basis shift.[705] Notwithstanding the foregoing, the Treasury regulations conclude this does not violate the anti-abuse provisions.[706]

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700. *Id.*
701. *Id.* § 1.701-2(d).
702. *Id.* § 1.701-2(d), ex. 9.
703. *Id.*
704. *Id.*
705. *Id.*
706. *Id.*

The second example involves a liquidating distribution of an appreciated, non-depreciable asset, and depreciable property with a basis equal to its fair market value.[707] The distribution resulted in a shift of basis from the non-depreciable asset to the depreciable asset (adding basis in excess of fair market value).[708] This resulted in additional depreciation deductions and tax benefits to the liquidated partner.[709] The example provides that the partnership and the liquidating partner had, as a principal purpose, the foregoing tax advantage to the liquidating partner.[710] However, the Treasury regulations conclude this does not violate the anti-abuse provisions.[711]

The Treasury regulations do provide an example of an abusive situation.[712] In that example, a partner contributes property with inherent loss to a partnership.[713] Related parties form and contribute cash to the partnership and then use it to purchase a nonmarketable security with a value and inside basis equal to the value of the contributed property.[714] The contributor will have a section 704(c) allocation of the inherent loss and an outside basis equal to the value of the contributed loss property.[715] A prospective purchaser who has an option to purchase will then lease the property for three years.[716] Three years later, but before the sale under the option, the contributor receives a liquidating distribution of the other property with an inside basis equal to the value of the contributed property.[717] The distributed property will have a distributed transferred basis equal to the basis of the contributed property, so that the contributor still has the original inherent loss.[718] The partnership with the contributed loss property recognizes the loss after the contributor has withdrawn from the partnership, resulting in a loss that is allocated to the related partners because the loss that would have been allocated under section 704(c) to the contributor is no longer a partner.[719] The Treasury regulations conclude that this situation is abusive.[720]

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707. *Id.*
708. *Id.*
709. *Id.*
710. *Id.*
711. *Id.* § 1.701-2(d), ex. 10.
712. *Id.* § 1.701-2(d), ex. 8.
713. *Id.* This transaction might have a different result today. Section 704(c)(1)(C), enacted in the American Jobs Creation Act of 2004, provides that contributed property has a "built-in loss" for purposes of allocating income to other partners, the inside basis will be treated as being equal to its fair market value at the time of contribution. I.R.C. § 704 (2012).
714. Treas. Reg. § 1.701-2(d).
715. *Id.*
716. *Id.*
717. *Id.*
718. *Id.*
719. *Id.*
720. *Id.* § 1.701-2(d), ex. 8; *see also* I.R.S. Field Service Advisory 2002-42-004 (Oct. 18, 2002) (involving a transfer of loss property to tax partnership, a sale of the partnership interest to unrelated party with no section 754 election in effect, followed by sale of loss property by the partnership; the transaction was recharacterized under Treas. Reg. § 1.701-2 as sale of assets).

Notwithstanding the existence of these anti-abuse rules, the IRS may also rely on nonstatutory principles like substance-over-form, step-transaction, and sham-transaction doctrines to recast certain partnership transactions.[721]

In addition to the anti-abuse rules, the codification of the economic substance doctrine under section 7701(o) is worth noting.[722] It provides, in part:

> [i]n the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.[723]

However, the Code provides an exception for "personal transactions of individuals" and "shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income."[724] It is unclear as to what extent this provision could apply to the planning techniques discussed in this article, particularly because this new paradigm in estate planning combines both transfer tax and income tax planning.[725]

C. Unitary Basis Rules

A partner has a "unitary basis" in his or her partnership interest, even if the partner has different classes of partnership interest (general and limited, preferred and common, etc.), and even if the partner acquired the partnership interests in different transactions.[726] This is in contrast to the "separate lot" rules applicable to shares of corporate stock when such separate lots can be "adequately identified."[727]

Under this unitary basis concept, basis is generally allocated in property to the relative fair market value of different interests when determining such basis allocation is relevant (for example, the sale of a partnership interest or a distribution of property in redemption of a partnership interest).[728] However, when partnership liabilities exist, the partner must take into account the

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721. Treas. Reg. § 1.701-2(i).

722. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067–71 (2010).

723. I.R.C. § 7701(o)(1) (2012).

724. *Id.* § 7701(o)(5)(B).

725. *See id.* § 7701(o).

726. Rev. Rul. 84-53, 1984-1 C.B. 159; *cf.* I.R.S. Priv. Ltr. Rul. 09-09-001 (Feb. 27, 2009) (suggesting the unitary basis rule does not apply to publicly traded partnership interests).

727. *See* Treas. Reg. § 1.1012-1(c) (as amended in 2010). Even if lots cannot be identified then a first-in, first-out accounting convention is used to determine gain or loss. *Id.*

728. *Id.*

changes in a partner's share of debt (deemed distributions and contributions of cash under section 752) when determining basis (corresponding additions or reductions of outside basis under sections 722 and 733).[729]

A partner will have a split holding period in his or her partnership interest if the partner acquires his or her partnership interest by contributing assets with different holding periods, or by subsequent contributions.[730] The split holding periods are allocated generally in proportion to the fair market value of the property in question.[731]

Unitary basis is determined on a partnership-by-partnership basis even if a partner has an interest in two or more partnerships that are identical in all respects (including the interests of other partners), except, perhaps the assets in the partnership, there does not seem to be a statutory rule that the unitary basis of the partner must be aggregated.[732] This may have important planning implications in estate planning because it might make sense for taxpayers to segregate low basis and high basis assets into different partnerships.[733]

D. Current and Liquidating Distributions

1. Non-Liquidating "Current" Distributions

a. Cash Distributions

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.[734] Because most FLPs are structured as "pro rata" partnerships,[735] 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,[736] unless cash distributed exceeds the outside basis of the partnership interest of any of the partners.[737]

Distributions of cash (including a reduction in a partner's share of liabilities and distributions of marketable securities)[738] to a partner reduces

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729. *See id*. § 1.752-1 (as amended in 2005).
730. *Id.*
731. *See id*. § 1.1223-3 (2000).
732. *Id.*
733. *Id.*
734. *Id*. § 1.761-1(d) (as amended in 1997).
735. This is generally due to the "same class" exception under section 2701(a)(2)(B). I.R.C. § 2701(a)(2)(B) (2012). With respect to this exception, the Treasury regulations provide that "[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) (as amended in 1994).
736. I.R.C. § 731(a)(1) (2012); Treas. Reg. §§ 1.731-1 (1960), 1.732-1(b) (as amended in 2004).
737. I.R.C. § 731(a)(1); Treas. Reg. § 1.731-1(a).
738. I.R.C. § 731(c); Treas. Reg. § 1.731-2.

the partner's outside basis, with gain recognized to the extent the cash distributed exceeds outside basis.[739] Additionally, no loss is ever recognized on a current distribution.[740] Any gain resulting from a current distribution of cash is considered capital gain that would result from a sale of the partner's interest.[741] 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).[742] The definitions of these types of assets (sometimes referred to as "hot assets") encompass more than might be obvious.[743] Unrealized receivables include rights to payment for goods or services not previously included in income,[744] and recapture property, but only to the extent unrealized gain is ordinary income (as discussed above).[745] "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)).[746]

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.[747] If the partner acquired his or her partnership interest by contributing property to the partnership (typically in a nonrecognition transaction), then the holding period of the property transferred is added to the partnership interest's holding period.[748] 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.[749]

One should note that if a partner transferred his or her partnership interest in exchange for cash (or other property), the tax rate on capital gain may be different than if the partner received cash from the partnership in liquidation or redemption of the partnership interest.[750]

Upon a sale or exchange, the transferor recognizes gain under rules similar to section 1001.[751] The transferee of the partnership interest takes a cost basis in the partnership interest equal to the consideration paid, and carries over

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739. I.R.C. § 733(a) (2012); Treas. Reg. § 1.733-1 (1960).
740. I.R.C. § 731(a)(2), (b). A loss may only occur with a liquidating distribution. Treas. Reg. § 1.731-1(a)(2).
741. I.R.C. § 731(a).
742. *Id.* § 751.
743. *Id.*
744. *Id.* § 751(b); Treas. Reg. § 1.751-1(b)(2), (d)(1) (as amended in 2004).
745. I.R.C. § 751(d).
746. *Id.*
747. *See* I.R.S. Gen. Couns. Mem. 39,196 (Jan. 1, 1975); Comm'r v. Lehman, 165 F.2d 383 (2d Cir. 1948).
748. I.R.C. §§ 1223(1)–(2), 721, 723 (2012); Treas. Reg. §§ 1.723-1 (as amended in 2004), 1.1223-1(b) (as amended in 1980).
749. Treas. Reg. § 1.1223-3(a)–(b), (f), ex. 1 (2000); *see* Capital Gains, Partnership, Subchapter S, and Trust Provisions, 65 Fed. Reg. 57,092 (Sept. 21, 2000) (to be codified at 26 C.F.R. pts. 1 & 602).
750. Treas. Reg. § 1.1223-3(a)–(b).
751. *See* I.R.C. § 741 (2012).

the transferor's capital account and share of forward and reverse section 704(c) gain in the partnership assets, if any.[752]

The character of the gain is capital subject to recharacterization under section 751(a).[753] The transferor partner recognizes ordinary income or loss in an amount equal to the income or loss that would be allocated to the partner if the partnership sold all of the partnership assets at fair market value.[754] Capital gain or loss is recognized in an amount equal to the gain or loss that an individual would calculate under section 1001 minus the ordinary income (or plus the ordinary loss) computed under section 751(a).[755]

All of the foregoing provides for similar results to a cash distribution to a partner.[756] On the other hand, for determining the rate of tax on the capital gain, one looks through to the underlying partnership assets.[757] Thus, depending on the assets held by the partnership, the transferor partner may recognize capital gain at a 20%, 25%, and 28% federal rate.[758]

b. Property Distributions

Neither the partner nor the partnership will recognize any gain or loss upon a distribution of property,[759] unless the property is a marketable security (treated as cash)[760] or is a "hot asset" under section 751 (mentioned above).[761] 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.[762]

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).[763] 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

752. Treas. Reg. §§ 1.704-1(b)(2)(iv)(b) (as amended in 2013), 1.704-3(a)(7) (as amended in 2013).
753. I.R.C. § 751.
754. Treas. Reg. § 1.751-1(a)(2) (as amended in 2004).
755. *Id.*
756. *Id.*
757. *See* I.R.C. § 1(h)(5)(B), (h)(9)–(10) (2012); Treas. Reg. § 1.1(h)-1(a) (2000).
758. *See* Treas. Reg. § 1.1(h)-(1)(a).
759. I.R.C. § 731(a)–(b); Treas. Reg. § 1.731-1(a)–(b) (1960). Although the "mixing bowl" rules may apply to trigger gain to a partner who contributed the distributed property. I.R.C. §§ 704(c)(2)(B), 737 (2012).
760. I.R.C. § 731(c); Treas. Reg. § 1.731-2 (as amended in 1997).
761. I.R.C. § 751 (2012).
762. Treas. Reg. § 1.752-1(e), (g) (as amended in 2005).
763. I.R.C. § 732(a)(1) (2012); Treas. Reg. § 1.732-1(a) (as amended in 2004). 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. I.R.C. § 743(b), (d) (2012). If the distributed property is not the property that was the subject of the basis adjustment under section 743(b), the adjustment is transferred to the distributed property in the same class (capital gain or ordinary property). Treas. Reg. § 1.755-1(a) (as amended in 2004).

property is encumbered with debt.[764] This limitation effectively transfers the inherent gain in the partnership interest (outside basis) to the distributed property.[765] When multiple properties are distributed and the outside basis limitation is triggered, the outside basis is first allocated to section 752 property and any excess to other property.[766] All other distributed property will have a zero basis once the outside basis is exhausted.[767]

Generally speaking, an individual will determine the character of the distributed property in the hands of the partner at the partner level, with the exception of unrealized receivables and inventory items, as defined in section 751(c) and 751(d).[768] This provision prevents a partner from converting an ordinary income item, like inventory in the partnership's hands, into a capital asset.[769] The holding period of the distributed property includes the holding period of the partnership.[770]

c. Partnership Inside Basis

When gain is recognized on a distribution (cash in excess of the outside basis), or when the basis of the distributed property is reduced because the outside basis is less than the basis of the property prior to the distribution, absent a section 754 election, there is no adjustment to the partnership's inside basis.[771] This may give rise to a temporary duplication of gain or to a loss of basis to the partnership and to the partners.[772]

If a section 754 election is made, an adjustment of basis under section 734(b) occurs when a partner recognizes gain due to a distribution (or deemed distribution) of cash in excess of outside basis, or property is distributed that results in a reduction of basis on the distributed property.[773] The adjustment results in an increase to the inside basis of the partnership assets.[774] The basis increase is allocated among two different classes of assets: (i) capital and section 1231 assets; and (ii) ordinary income property.[775] Any basis adjustment due to gain from a distribution of cash must be allocated to capital assets.[776] Any increased basis adjustment is first allocated to appreciated property in

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764. *See* Treas. Reg. §§ 1.732-1 (as amended in 2004), 1.736-1(b)(1) (as amended in 1965), 1.743-1(d)(1) (as amended in 2004).

765. *See id*. § 1.732-1.

766. I.R.C. § 732(c)(1)(A)(i); Treas. Reg. § 1.732-1(c)(1)(i).

767. *See* Treas. Reg. § 1.732-1.

768. I.R.C. § 735(a) (2012).

769. *See id.*

770. *Id*. § 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. *Id.*

771. *See id.* § 754.

772. *See id.*

773. *Id*. § 734(b)(1).

774. *Id.*

775. Treas. Reg. § 1.755-1(a)(1), (c)(1) (as amended in 2004).

776. *Id.* § 1.755-1(c)(1)(ii).

proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class in proportion to fair market values.[777] Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners.[778] Adjustments under section 734(b) are discussed in more detail later in this article.[779]

2. Liquidating Distributions

Liquidating distributions (whether in one distribution or a series of distributions) terminate the liquidated partner's entire interest in a partnership.[780] Liquidating distributions are treated the same as current distributions except a loss may be recognized,[781] and the basis of property distributed to a partner may be increased (discussed below).[782] The only way to recognize a loss upon a liquidating transfer is if the distribution consists only of cash (but not including marketable securities)[783] and section 751 assets (hot assets).[784]

In the estate planning context, most partnerships are structured as pro rata or single class share partnerships because of the "same class" exception under section 2701(a)(2)(B).[785] With respect to this exception, the Treasury regulations provide, "A class is the same class as (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)."[786] In order to qualify for this exception, it generally requires that distributions must be made proportionately and at the same time (and perhaps with the same assets).[787] In order to effectuate a disproportionate distribution of property, for example, to an older partner with limited outside basis (trying to maximize the benefit of the step-up), one would need to redeem a portion of the partner's interest (lower the percentage ownership), which would be considered a current distribution, or liquidate the partner.[788]

777. *Id.* § 1.755-1(c)(1)(i).
778. *See id.*
779. *See infra* Part V.D.2.
780. I.R.C. § 761(d) (2012).
781. *Id.* § 731(a)(2); Treas. Reg. § 1.731-1(a)(2) (1960).
782. I.R.C. § 732(b), (c); Treas. Reg. § 1.732-1(b) (as amended in 2004).
783. I.R.C. § 731(a)(1)–(2), (c)(1). Section 731(c)(1) refers to section 731(a)(1), the gain provision, not section 731(a)(2), the loss provision.
784. *Id.* § 731(a)(2); Treas. Reg. §§ 1.731-1(a)(2), 1.732-1(c)(3).
785. I.R.C. § 2701(a)(2)(B) (2012).
786. Treas. Reg. § 25.2701-1(c)(3) (as amended in 2004).
787. I.R.C. § 2701(a)(2)(C).
788. *See* Treas. Reg. § 1.732-1.

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 that the basis in section 751 assets cannot exceed the transferred basis.[789] However, basis of other distributed property can be increased if the liquidated partner's outside basis (reduced by cash distributed and adjusted for any change in the partner's share of liabilities as a result of the distribution) is greater than the inside basis of the distributed assets.[790] If the transferred basis is in excess of the fair market value of the distributed asset, then a loss can be recognized on a subsequent sale or, if the property is depreciable, depletable, or amortizable, the added basis can provide tax benefits in the form of ongoing deductions.[791]

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.[792] With respect to liquidating distributions, the inside basis adjustments may be increased or decreased (rather than only increased in a current distribution).[793] This is because a liquidating distribution may result in a loss to the withdrawing partner, and a property distribution may result in an increased tax basis.[794] Another difference with liquidating distributions exists when there is a substantial basis reduction.[795] 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," which will exist if the amount exceeds $250,000.[796] 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.[797]

Adjustments for the gain or loss on the partnership interest, 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.[798] 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

789. I.R.C. § 732(c)(1)(A); Treas. Reg. § 1.732-1(c)(1)(i).
790. I.R.C. § 732(b); Treas. Reg. § 1.732-1(b).
791. Treas. Reg. § 1.732-1(d)(4).
792. *See* I.R.C. § 734(a) (2012).
793. *See id*. § 734(b)(1), (2).
794. *Id*. § 734(b)(2)(A)–(B); Treas. Reg. § 1.734-1(b) (as amended in 2004).
795. *See* I.R.C. § 734(b).
796. *Id*. § 734(a), (d). The subsection refers to section 734(b)(2)(A), which in turn refers to section 731(a)(2) relating to liquidating distributions, and section 734(b)(2)(B), which refers to section 732(b) also relating to liquidating distributions.
797. *Id*. § 734(d)(1).
798. Treas. Reg. § 1.755-1(a) (as amended in 2004).

adjustment for another.[799] 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.[800] Similarly, reductions in partnership assets are first allocated to property that has declined in value in proportion to the unrealized loss and then to all properties in proportion to their adjusted basis.[801]

3. Mixing Bowl Transactions

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.[802] The partnership would be treated as a "mixing bowl" where assets are commingled and then the partnership is dissolved, with each partner walking away with a different mixture of assets.[803] As a result of this perceived abuse, Congress enacted the "mixing bowl transaction" provisions of sections 704(c)(1)(B) and 737.[804] These provisions can be triggered when contributed property is distributed to another partner or if other property is distributed to a contributing partner.[805]

a. Contributed Property to Another Partner-Section 704(c)(1)(B)

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.[806]

The amount of such gain or loss will generally equal the lesser of: (a) the difference between the fair market value of the contributed property at the time it 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.[807] 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.[808] The

799. *Id*. § 1.755-1(c)(2).
800. *Id*. § 1.755-1(c)(2)(i).
801. *Id*. § 1.755-1(c)(2)(ii).
802. *See* I.R.C. § 1031 (2012).
803. *See id*. §§ 704, 737.
804. *See id*. §§ 704(c)(i)(B), 737.
805. *See id.*
806. *Id*. § 704(c)(1)(B).
807. *Id*. § 704(c)(2)(B)(i); Treas. Reg. § 1.704-4(a) (as amended in 2005).
808. I.R.C. § 704(c)(1)(B)(i).

character of any such gain or loss is determined by the character of the contributed securities in the hands of the partnership.[809]

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).[810] 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.[811]

Similar to the general anti-abuse provisions mentioned above, the Treasury regulations provide 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)," based on all the facts and circumstances, the IRS can recast the transaction appropriately.[812] 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 section 704(c)(1)(B) period (now seven years), adding a partner to whom the contributed property will be distributed.[813] 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.[814]

b. Other Property Distributed to Contributing Partner—Section 737

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.[815] 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 that gain would not be triggered unless the partnership actually sold the property in a taxable transaction.[816] 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 section 737 gain.[817]

809. Treas. Reg. § 1.704-4(b).
810. *Id.* § 1.704-4(d)(1)(i).
811. I.R.C. § 704(c)(1)(B)(iii); Treas. Reg. § 1.704-4(e).
812. Treas. Reg. § 1.704-4(f)(1).
813. *Id.* § 1.704-4(f)(2), ex. 2.
814. *Id.*
815. I.R.C. §§ 704(c)(1)(B), 737.
816. Treas. Reg. § 1.737-3(c)(3) (as amended in 1996).
817. I.R.C. § 737(d)(1); Treas. Reg. § 1.737-3(d).

Unlike section 704(c)(1)(B), section 737 only applies to gain, not loss.[818] 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.

The amount of the gain is equal to the lesser of: (a) "net precontribution gain" (aggregate net gain, as reduced by any loss property, that would be realized under section 704(c)(1)(B) if all of the property contributed by the contributor within seven years of the distribution—and still owned by the partnership—had been distributed to another partner); or (b) the excess of the fair market value of the distributed property over the outside basis of the partnership interest, determined with adjustments resulting from the distribution without regard to the gain triggered by section 737.[819] "The character of [the] gain shall be determined by reference to the proportionate character of the net precontribution gain," which is to say, it is generally determined by its character in the hands of the partnership.[820]

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.[821] Further, the basis of the distributed property is adjusted to reflect the recognized gain on the partner's outside basis.[822] Marketable securities are generally treated as cash for purposes of section 737.[823] However, in determining "net precontribution gain" under section 737, marketable securities contributed to the partnership are treated as contributed property.[824]

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 purpose of Section 737."[825] 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).[826] Gain under section 737 would be avoided because the contribution increased the outside basis of the contributing partner.[827] Then, the partnership liquidates the contributing partner's interest in a nontaxable distribution, returning the contributed property, which has been temporarily parked in the partnership to

818. I.R.C. § 737(a).
819. *Id.* § 737(a)(1), (2); *see* Treas. Reg. § 1.737-1(c)(2)(iv), (e), ex. 2.
820. I.R.C. § 737(a)(2); Treas. Reg. § 1.737-1(d).
821. I.R.C. § 737(c); 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), 1.737-3(e), ex. 3.
822. I.R.C. § 737(c)(1); Treas. Reg. § 1.737-3(b)(1).
823. I.R.C. § 737(c)(1), (e); Treas. Reg. § 1.731-2(a) (as amended in 1997).
824. Treas. Reg. § 1.731-2(g)(i)–(iii).
825. *Id.* § 1.731-4(a).
826. *Id.* § 1.737-4(b), ex. 1.
827. *Id.*

avoid gain on the distribution of other property prior to the liquidation of the partner's interest.[828]

4. Disguised Sale Rules

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 may cause the partner to recognize gain (as of the original date of contribution), with respect to his or her contributed property under the disguised sale rules.[829]

Distributions within two years are presumed to be part of a disguised sale, and those more than two years are presumed not to be part of a disguised sale.[830] Distributions in a transaction determined to be a disguised sale are treated as payments by the partnership to the disguised seller-partner, acting in an independent capacity and not as a partner.[831]

5. Distributions of Securities

A distribution consisting of marketable securities is generally treated as a distribution of cash, rather than property.[832] For these purposes, marketable securities include financial instruments (stocks, equity interests, debt, options, forward or futures contracts, notional principal contracts, and other derivatives) and foreign currencies that are actively traded.[833] 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;[834] (2) distributions of securities that were not marketable when acquired by the partnership;[835] and (3) distributions of securities from an "investment partnership" to an "eligible partner."[836]

An investment partnership is defined as a partnership in which substantially all of the assets consist of specified investment-type assets and that has never been engaged in a trade or business.[837] Specified investment-type

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828. *Id.* § 1.731-4(b), ex. 1.
829. I.R.C. § 707(a)(2)(B) (2012).
830. Treas. Reg. § 1.707-3(c)–(d) (1992).
831. I.R.C. § 707(a)(2); Treas. Reg. § 1.707-3(c).
832. I.R.C. § 731(c) (2012).
833. *Id.* § 731(c)(2)(A), (c)(2)(C).
834. *Id.* § 731(c)(3)(A); Treas. Reg. § 1.731-2(d)(1) (as amended in 1997).
835. I.R.C. § 731(c)(3)(A)(ii); 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 six months prior to the security becoming marketable, and the partnership must "distribute the security within five years from the date the security became marketable." Treas. Reg. § 1.731-2(d)(1)(iii)(A)–(C).
836. I.R.C. § 731(c)(3)(C)(i), (c)(3)(A)(iii).
837. *Id.* § 731(c)(3)(C)(i).

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) interest in or derivative financial instruments (including options, forward or future contracts, and short positions).[838] "A partnership shall not be treated as engaged in a trade or business by reason of any activity undertaken as an investor, trader, or dealer in [such specified investments]."[839]

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.[840]

If one of these exceptions do not apply, a distribution of marketable securities may result in gain to the distributee partner to the extent the value of the marketable securities exceeds outside basis.[841] The amount of marketable securities treated as cash is reduced (and the potential recognized gain is reduced) by:

> (1) 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[842]
>
> (2) 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 . . . .[843]

Moreover, any unrealized loss in the marketable securities is not recognized, either by the partnership or the partner.[844]

If gain is recognized on the distribution of marketable securities under section 731(c), the tax basis of the distributed securities is increased by the amount of such gain, allocated to the distributed securities in proportion to unrealized appreciation.[845] If no gain is recognized, the basis of the marketable securities in the hands of the partner is the inside basis under the general rule of section 732.[846] It is important to keep in mind that section 731(c) applies only for purposes of determining gain to the partner.[847] The

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838. *Id.* § 731(c)(3)(C)(i)(I)–(VIII).
839. *Id.* § 731(c)(3)(C)(ii)(I); Treas. Reg. § 1.731-2(e)(3)(i).
840. I.R.C. § 731(c)(3)(C)(iii)(I).
841. *Id.* § 731(c)(3)(B); Treas. Reg. § 1.731-2(a), (j), ex. 1.
842. I.R.C. § 731(c)(3)(B)(i).
843. *Id.* § 731(c)(3)(B)(ii).
844. *Id.* § 731(b).
845. *Id.* § 731(c)(4); Treas. Reg. § 1.731-2(f)(1)(i).
846. *See* I.R.C. § 731(c)(4)(A)(i).
847. *See id.* § 731(a).

partner's outside basis is still determined under the general rules of section 733.[848] As such, when gain is recognized upon a distribution of marketable securities, the partner's outside basis, by definition, is reduced to zero.[849] Any gain recognized by the partner is not reflected in the partner's outside basis, rather it is reflected in the securities received.[850]

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.[851]

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.[852] However, if a section 754 election is in place, the inside basis of the 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).[853]

E. Partnership Liabilities and Basis

The partnership rules make an important distinction between recourse and nonrecourse liabilities.[854] In this context, generally, recourse liabilities increase basis only as to the partner who bears economic risk of loss, whereas nonrecourse liabilities increase basis proportionately among all of the partners.[855] A partnership liability is considered recourse "if any partner or related person bears the economic risk of loss for [the] liability."[856] Conversely, a liability is considered nonrecourse "to the extent no partner or related person bears such risk of loss."[857]

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 cash by the partner in the partnership, thereby increasing basis.[858] Any decrease is treated as a distribution of cash to the partner, thereby reducing basis and possibly resulting in the recognition of gain if the amount of the deemed

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848. *See id.* § 733.
849. *See id.* §§ 732–33; *see also* Treas. Reg. § 1.731-2(f)(l)(i)–(ii).
850. *See* I.R.C. §§ 732–33; *see also* Treas. Reg. § 1.731-2(f)(l)(i)–(ii).
851. I.R.C. § 731(a)(1); Treas. Reg. § 1.731-2(f)(1)(ii), (j), ex. 5.
852. I.R.C. § 731(a)(1); Treas. Reg. § 1.731-2(f)(1)(ii), (j), ex. 5.
853. *See* Treas. Reg. § 1.731-2(j), ex. 6(iv).
854. *Compare* Treas. Reg. § 1.752-2 (as amended in 2006) (setting out the rules for determining partners' share of recourse liabilities), *with* Treas. Reg. § 1.752-3 (as amended in 2000) (distinguishing the rules for determining nonrecourse liabilities).
855. *See generally* Treas. Reg. §§ 1.752-2, 1752-3.
856. *Id.* § 1.752-1(a)(1) (as amended in 2005).
857. *Id.* § 1.752-1(a)(2).
858. I.R.C. § 722 (2012); Treas. Reg. § 1.752-1(b).

distribution exceeds available outside basis.[859] 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.[860]

A partner or related person will be deemed to bear the economic risk of loss for a partnership liability "if the partner or related person would be obligated to make a payment to any person [like a third-party lender] (or a contribution to the partnership)" upon a constructive liquidation of the partnership.[861] Whether such payment or contribution obligation exists (and the extent of such obligation) depends on all the facts and circumstances, like the existence of the following:

a. Contractual obligations like "guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;"[862]

b. Partnership obligations including "the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership;"[863]

c. Payment obligations "imposed by state law, including the governing state partnership statute;"[864] and

d. Reimbursement rights a partner or related person may have from "another partner or a person who is a related person to another partner."[865]

In making a determination of whether a partner or related person has a payment obligation on a partnership liability and bears the economic risk of loss, it is assumed the partner or related person will be able to pay the obligations "irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation."[866] The Treasury regulations state that a person will be a "related person" to a partner if they have a relationship that is specified in sections 267(b) and 707(b)(1) but with a few modifications.[867] Including those modifications, a person is related to a partner if they are (in part):

> (1) Members of a family [(spouse, ancestors, and lineal descendants)];
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> (2) An individual and a corporation [if more than 80 percent of value of the outstanding stock of the corporation] is owned, directly or indirectly, by or for such individual;

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859. I.R.C. §§ 733, 731(a), 751 (2012); Treas. Reg. § 1.752-1(c).
860. Treas. Reg. § 1.752-1(e).
861. *Id.* § 1.752-2(b)(1).
862. *Id.* § 1.752-2(b)(3)(i).
863. *Id.* § 1.752-2(b)(3)(ii).
864. *Id.* § 1.752-2(b)(3)(iii).
865. *Id.* § 1.752-2(b)(5).
866. *Id.* § 1.752-2(b)(6).
867. *Id.* § 1.752-4(b)(1).

> . . . .
>
> (4) A grantor and a fiduciary of any trust;
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> (5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
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> (6) A fiduciary of a trust and a beneficiary of such trust;
>
> (7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
>
> (8) A fiduciary of a trust and a corporation [if more than 80 percent of the value of the outstanding stock of the corporation] is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
>
> (9) A person and [a charitable] organization . . . [if the organization] is controlled directly or indirectly by such person or (if the person is an individual) by members of the family of such individual;
>
> (10) A corporation and a partnership if the same persons own more than [80] percent in value of the outstanding stock of the corporation, and more than [80] percent of the capital interest, or the profits interest, in the partnership;
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> (11) An S corporation and another S corporation, if the same persons own more than [80] percent in value of the outstanding stock of each corporation;
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> (12) An S corporation and a C corporation, if the same persons own more than [80] percent in value of the outstanding stock of each corporation;
>
> (13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate;
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> . . . .
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> [(14)] a partnership and a person owning, directly or indirectly, more than [80] percent of the capital interest, or the profits interest, in such partnership; or
>
> [(15)] two partnerships in which the same persons own, directly or indirectly, more than [80] percent of the capital interests or profits interests.[868]

To avoid double counting, the Treasury regulations provide that "persons owning interests directly or indirectly in the same partnership are not treated as related persons for purposes of determining" their share of partnership loss.[869] The Treasury regulations further provide that if:

868. I.R.C. §§ 267(b), 707(b)(1)(A)–(B) (2012).

869. Treas. Reg. § 1.752-4(b)(2)(iii).

> (1) A partnership liability is owned or guaranteed by another entity that is a partnership, an S corporation, a C corporation, or a trust; (2) A partner or related person owns (directly or indirectly) a 20 percent or more ownership interest in such other entity; and (3) A principal purpose of having the other entity act as a lender or guarantor was to avoid the determination that the partner that owns the interest bears the economic risk of loss for federal income tax purposes for all or part of the liability; then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner's or related person's ownership interest in the entity.[870]

The ownership interest of the partner and related person are determined according to each entity in the following manner:

a. Partnership: highest percentage interest in any partnership loss or deduction for any taxable year;

b. S corporation: percentage of outstanding stock owned by the shareholder;

c. C corporation: percentage of the issued and outstanding stock owned by the shareholder based upon fair market value; and

d. Trust: actuarial percentage interest owned by the beneficiary.[871]

An otherwise nonrecourse partnership liability is treated as a recourse liability to the extent that a partner or a related person holds an interest in the liability, referred to as "partner nonrecourse debt" in the Treasury regulations.[872] In such case, the economic risk of loss is allocated to such partner (or related person) to the extent not otherwise allocated to another partner.[873]

If a partner (or related person) pledges property outside the partnership (a direct pledge) as security for a partnership liability, the partner bears the risk of loss to the extent of the "net fair market value" of the pledged property.[874] If a partner contributes property to a partnership solely for the purpose of securing a partnership liability (an indirect pledge), the partner is deemed to bear the risk of loss to the extent of the net fair market value of the pledged property.[875] Contributed property is not indirectly pledged unless "substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction."[876]

870. *Id.* § 1.752-4(b)(2)(iv)(A).
871. *Id.* § 1.752-4(b)(2)(iv)(B).
872. *See id.* § 1.704-2(b)(4).
873. *Id.* § 1.752-2(c)(1).
874. *See id.* § 1.752-2(h)(1).
875. *See id.* § 1.752-2(h)(2).
876. *Id.*

As with other partnership provisions, the Treasury regulations contain anti-abuse rules that would disregard the form of the situation "if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise."[877] The Treasury regulations discuss two situations:

a. Arrangements tantamount to a guarantee:[878]

> (i) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain a loan;[879]
>
> (ii) The contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan;[880] and
>
> (iii) One of the principal purposes . . . is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.[881]

b. A plan to circumvent or avoid the obligation, based on the facts and circumstances, of a partner (or related person).[882]

A complete discussion of how nonrecourse liabilities are shared by partners is beyond the scope of this article, but the Treasury regulations generally provide that a partner's share of such liabilities are the sum of:[883]

a. 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);[884]

b. The amount of any taxable gain that would be allocated, under section 704(c), to the partner (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

877. *Id.* § 1.752-2(j)(1).

878. *Id.* § 1.752-2(j)(2); *see* I.R.S. Chief Counsel Advisory 2002-46-014 (Nov. 15, 2002) (showing a guarantee was disregarded due to a number of factors including severe undercapitalization and the existence of many waivers and defenses for the benefit of the purported guarantor).

879. Treas. Reg. § 1.752-2(j)(2)(i).

880. *Id.*

881. *Id.* § 1.752-2(j)(2)(iii).

882. *Id.* § 1.752-2(j)(3). The statute provides an example of a general partnership, a minimally capitalized corporation as a partner, and a deficit capital account restoration obligation. *Id.* § 1.752-2(j)(4). The obligations of the corporate partner and the capital account restoration obligation are ignored for purposes of section 752. *See id.*

883. *Id.* § 1.752-3(c)(iii). Sometimes referred to as the sum of tier one, tier two, and tier three allocations.

884. *See id.* § 1.704-2(d)(1).

taxable transaction in full satisfaction of the liabilities and for no other consideration;[885] and

c. The partner's share of "excess nonrecourse liabilities" (liabilities not allocated above).[886]

A partner's share of excess nonrecourse liabilities is "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."[887] As a result, if an FLP has pro rata shares (as is common), and no partner has made a contribution of property to the partnership, then nonrecourse debt will also be shared pro rata.[888]

F. Section 754 Election and Inside Basis Adjustments

1. General

As discussed above, whether a partnership has a section 754 election in place has a direct bearing on the inside basis of the assets held by a partnership.[889] Those adjustments to the basis are made pursuant to section 743, when there is a sale or exchange of a partnership interest or a death of a partner occurs, and pursuant to section 734, when there is a distribution to a partner.[890]

Generally, the inside basis of partnership assets are not adjusted when a partnership interest is sold or exchanged, when a partner dies, or when there is a distribution of property to partners.[891] These transactions can create discrepancies between inside and outside basis, which in turn can create distortions in the amount of income recognized and the timing of the income.[892] For example, if a partner dies or a partner sells his or her partnership interest, the transferee partner will have a basis in the partnership interest equal to fair market value or the cost of the sale.[893] If that basis is greater than the inside basis of the assets then when the partnership sells those assets, additional gain will be allocated to the transferee partner.[894] Similarly, if a partnership makes a liquidating distribution to a partner for cash, and the partner recognizes gain as a result of that distribution because the partner's outside basis is less than the cash distributed, then that gain essentially

885. *Id.* § 1.752-3(a)(2).
886. *Id.* § 1.752-3(a)(3).
887. *Id.*
888. *See id.*
889. *See* I.R.C. § 754 (2012).
890. *See id.*
891. *See id.* § 743(a).
892. *See id.*
893. *See* Carol A. Cantrell, *Section 754: Making the Election or Not*, A.B.A 9–10 (Sep. 24, 2009), http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/joint_fall/2009/spratt_2009 0907145241093.authcheckdam.pdf.
894. *See id.*

represents the liquidated partner's share of appreciation in the partnership.[895] Absent an adjustment to inside basis, a subsequent sale of the partnership assets will result in that gain being allocated to the remaining partners.[896] The adjustments under sections 743 and 734 attempt to adjust for those types of discrepancies.[897] Adjustments can increase or decrease the inside basis of partnership property.[898]

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.[899] 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.[900]

The adjustments under sections 743(b) are mandatory, even in the absence of a section 754 election, if the partnership has a substantial built-in loss immediately after the sale or exchange, upon death (an adjustment under section 743(b)), or if there is a substantial basis reduction with respect to a distribution (an adjustment under section 734(b)).[901] There is a substantial built-in loss if the partnership's inside basis on all partnership property exceeds the fair market value by more than $250,000.[902] There is a substantial basis reduction resulting from a distribution of property if the sum of the following exceeds $250,000: (i) a loss to the partner (only upon a liquidating transfer, as discussed above); and (ii) excess basis of the distributed property in the hands of the partner over the inside basis prior to the distribution.[903]

The adjustments under section 743(b) result in either: (1) an increase in the transferee's share of partnership inside basis "by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property;"[904] or (2) a decrease in the transferee's share of partnership inside basis "by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership."[905]

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895. *See id.*

896. *See id.*

897. *See* I.R.C. §§ 734(b)(1)–(2), 743(b) (2012).

898. *See* I.R.C. §§ 734(b)(1)–(2), 743(b).

899. Treas. Reg. § 1.754-1(b)(1) (as amended in 2000). Under certain circumstances, there is a twelve month extension past the original deadline. *Id.* § 301.9100-2 (as amended in 1997).

900. *See* I.R.C. § 754 (2012); Treas. Reg. § 1.754-1(a). An election may be revoked if there exists: (i) a change in the nature of the partnership business; (ii) a substantial increase in or a change in the character of the partnership's assets; or (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). Treas. Reg. § 1.754-1(c)(1).

901. *See* I.R.C. § 743(a) (2012).

902. *Id.* § 743(d)(1).

903. *Id.* § 734(b)(2), (d).

904. *Id.* § 743(b)(1).

905. *Id.* § 743(b)(2).

A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities.[906] The partner's previously taxed capital is:

(a) 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; increased by

(b) The amount of tax loss that would be allocated to the partner on the hypothetical transaction; and decreased by

(c) The amount of tax gain that would be allocated to the partner on the hypothetical transaction.[907]

The partner then allocates the inside basis adjustment under section 743(b) among the partnership property under the rules set out in section 755.[908] Generally, section 755 seeks to reduce the difference between the fair market value of partnership assets and the adjusted tax basis of the partnership in such assets.[909] In allocating the adjustment, to the extent that the adjustment is attributable to property consisting of (1) capital assets and section 1231(b) property (capital gain property) and (2) any other property, the adjustment "must be allocated to partnership property of a like character" (ordinary income property).[910] The partnership first allocates the adjustment between the capital gain property and ordinary income property, then the partnership allocates the adjustment among the assets within these two asset categories.[911]

Section 734(b) (upon distribution of partnership property to a partner) applies to the common inside basis of the partnership assets, which favors all of the parties in the partnership (not just for the benefit of the transferee) by making the basis adjustment in favor of all of the partners, unlike basis adjustments under section 743(b).[912] "Partnership property" is increased or decreased using section 734(b)(1) and 734(b)(2).[913] In contrast, adjustments under section 743(b) "shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only."[914]

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906. Treas. Reg. § 1.743-1(d)(1) (as amended in 2004).
907. *See id.* § 1.743-1(d)(1)(i)–(iii), (d)(2).
908. *See* I.R.C. §§ 743(b), 755 (2012).
909. *Id.* § 755(a).
910. *Id.* § 755(b).
911. Treas. Reg. § 1.755-1(a)(1) (as amended in 2004).
912. *See* I.R.C. § 734(b) (2012).
913. *See id.* § 734(b)(1)–(2).
914. *Id.* § 743(b).

G. Partnership Divisions

1. Generally

Generally, neither the Code nor state law specifically defines divisions of partnerships.[915] A partnership division is any transaction that converts a single partnership into two or more resulting partnerships.[916] There are a number of different ways to accomplish a division of a partnership, sometimes referred to as assets-over, assets-up, and interests-over.[917]

Assets-Over: Divided partnership contributes some of its assets (and perhaps liabilities) to a recipient partnership in exchange for an interest in the recipient partnership, followed by a distribution of the interests in the recipient partnership to the partners.[918]

Assets-Up: Divided partnership contributes some of its assets (and perhaps liabilities) to some or all of its partners, and the partners then contribute those assets (and liabilities, if any) to the recipient partnership for interests in the recipient partnership.[919]

Interests-Over: Some, or all, of the partners in the divided partnership contribute a portion of their interest in the divided partnership to the recipient partnership in exchange for interests in the recipient partnership, followed by a liquidated distribution of assets (and perhaps liabilities) into the recipient partnership.[920]

To avoid unintended transfer tax consequences, tax planners must be wary of the special valuation rules of Chapter 14, in particular section 2701.[921] Section 2701 includes a "transfer" of an interest in a family-controlled partnership to a member of the transferor's family, pursuant to which the transferor keeps an applicable retained interest.[922] Transfer has a broad definition and includes "a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership."[923]

Importantly in this context, section 2701 does not apply to a transfer "to the extent the transfer by the individual results in a proportionate reduction

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915. *See generally id.* § 708(2)(B) (discussing division of a partnership).

916. *See id.*

917. Cassady V. Brewer, Coming Together and Breaking Apart: Planning and Pitfalls in Partnership Mergers and Divisions, Presented at the 43rd Annual Southern Federal Tax Institute (Sept. 2008), Outline F, F-13; *see* Alicia Koross, *Assets-Over or Assets-Up: Your Call*, ACCT. TODAY (Aug. 12, 2008), http://www.accountingtoday.com/news/ 28759-1.html.

918. *See* Koross, *supra* note 917.

919. *See id.*

920. *See* Gregory Marks, *Understanding and Selecting the Best Conversion or Merger Approach for Pass-Through Entities*, GREENBERG TRAURIG LLP (July 2002), http://www2.gtlaw.com/pub/articles/2002/marksg02b.asp.

921. *See* I.R.C. § 2701(a) (2012).

922. *Id.* § 2701.

923. *Id.* § 2701(e)(5).

of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer."[924] The Treasury regulations provide the following example:

> section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate, by 10 percent even if the transfer does not proportionately reduce P's interest in each class.[925]

This exception is often referred to as the "vertical slice exception."[926]

In addition, section 2701 does not apply to any right with respect to an applicable retained interest if that interest is in the same class as the transferred interest or the same as the transferred interest—without regard to a nonlapsing difference in voting power or, for a partnership, nonlapsing differences with respect to management and limitations on liability.[927]

Consequently, most divisions of partnerships for estate planning purposes (assuming no gifts are intended as a result of the division) will result in partners from the divided partnership being the same partners in the recipient partnership and retaining the same pro rata interest in both the divided and recipient partnership.[928]

2. *Tax Treatment of Partnership Divisions*

Section 708 governs partnership divisions.[929] The Treasury regulations issued in 2001 provide that the IRS will not respect the interests-over form of partnership division described above.[930] In addition, the Treasury regulations respect both the assets-over method and the assets-up method; however, the IRS prefers the assets-over method.[931]

In the assets-over form method, the divided partnership transfers assets to the recipient partnership in exchange for interest in the recipient partnership, followed by a distribution of the recipient partnership's interests to the partners.[932] Parity of ownership interests will likely exist between the divided partnership and the recipient partnership because of the Chapter 14

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924. Treas. Reg. § 25.2701-1(c)(4) (as amended in 1994).

925. *Id.*

926. *See generally id.* (demonstrating when section 2701 does not apply).

927. I.R.C. § 2701(a)(2)(B)–(C). Nonlapsing provisions that are necessary to comply with the partnership allocation requirements will be treated as nonlapsing differences with respect to limitations on liability. *See* Treas. Reg. § 25.2701-1(c)(3).

928. *See generally* I.R.C. § 2701(a) (demonstrating when section 2701 does not apply).

929. *See id.* § 708(b)(2)(B).

930. *See* Partnership Mergers and Divisions, 66 Fed. Reg. 71,501 (Jan. 4, 2001).

931. *See* Treas. Reg. § 1.708-1(d)(3) (as amended in 2014).

932. *Id.* § 1.708-1(d)(3)(i)(A). The divided partnership of all the interests in the recipient partnership ignores the transitory ownership. *Id.* § 1.708-1(d)(5), ex. 3–6.

considerations mentioned above.[933] As such, the partner's distribution of the recipient partnership interest is current distribution rather than liquidated distribution because no partner is terminating his or her divided partnership interest.[934] Because of this parity of ownership, the mixing bowl transaction (as discussed above) is unlikely to trigger any gains or losses.[935] Furthermore, the preamble to the Treasury regulations points out that when a division results in a pro rata division, section 704(c) implications do not exist.[936] Similarly, given the parity of ownership before and after the division, no gain results from a deemed distribution of cash under section 752 because the partner's share of liabilities does not result in a change.[937]

The resulting basis that the partners have in their respective interests in the divided partnership and the recipient partnership depend on what assets and liabilities are contributed and distributed as a result of the division.[938]

In a division, the Treasury regulations provide that a "resulting partnership" (a partnership that has at least two partners from the prior partnership) will be considered a continuation of the prior partnership if the partners in the resulting partnership "had an interest of more than 50 percent in the capital and profits of the prior partnership."[939] All resulting partnerships that the Code considers a continuation of the prior partnership are subject to all preexisting tax elections (for example, a section 754 election) that were made by the prior partnership.[940] Thus, in pro rata divisions, where all of the partners retain the same ownership in the resulting partnerships, all of the resulting partnerships will be considered continuing partnerships, retaining all prior tax elections of the divided partnership.[941]

There is a narrow anti-abuse provision in the Treasury regulations with respect to partnership divisions.[942] It provides that if a partnership division is "part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with the form . . . the [IRS] . . . may recast the larger series of transactions in accordance with their substance."[943]

933. *See id.* § 1.708-1(d)(i)(A).

934. *See id.*

935. I.R.C. §§ 704(c)(1)(B), 737 (2012); Treas. Reg. §§ 1.704-4(c)(4) (as amended in 2005), 1.737-2(b)(2) (as amended in 2005).

936. *See* Partnership Mergers and Divisions, 66 Fed. Reg. 71,501 (Jan. 4, 2001). Non-pro rata divisions are still under review. *Id.*

937. *See* I.R.C. § 752(b) (2012).

938. *See id.* § 704(c).

939. Treas. Reg. § 1.708-1(d)(1), (d)(4)(iv).

940. *Id.* § 1.708-1(d)(2)(ii).

941. *See* I.R.S. Priv. Ltr. Rul. 90-15-016 (Apr. 13, 1990) (stating the finding for seven continuing partnerships with the same owners in the same proportions).

942. *See* Treas. Reg. § 1.708-1(d)(6).

943. *Id.* § 1.708-1(d)(6), (c)(6)(ii) (showing an example of an abusive series of transactions that involved a partnership division and merger).

3. Partnership Divisions in Tax Basis Management

The importance of tax-free partnership divisions in the new paradigm of estate planning cannot be overstated. The unitary basis rules applicable to partnership interests do not allow taxpayers to differentiate between low or high basis lots of partnership interests.[944] The partnership division rules effectively allow taxpayers to segregate particular assets within a partnership into a new partnership and provide a separate outside basis in those assets through the new partnership.[945] The outside basis of the partner's interest determines the basis of the partnership property distributed in-kind to a partner. Careful partnership divisions allow taxpayers to determine what the tax basis of the in-kind property will be upon distribution, rather than determined by an aggregate basis under the unitary basis rule.[946]

Furthermore, divisions allow taxpayers to isolate the particular assets that they wish to benefit from an inside basis adjustment under sections 743 and 734.[947] As mentioned above, the inside basis adjustments under section 755 are made at an entity level and apply across all of the assets within the partnership.[948] Careful partnership divisions would allow taxpayers to determine what assets would be the subject of the inside basis adjustment and perhaps separately choose to make a section 754 election for the new partnership rather than the original partnership.[949]

H. Death of a Partner

1. Generally

The transfer of a deceased partner's interest in a partnership will not result in gain or loss even if the deceased partner's share of liabilities exceeds outside basis.[950] The estate's outside basis in the partnership will equal the fair market value of the partnership interest for estate tax purposes (which is the net of partnership liabilities), plus the estate's share of partnership liabilities, minus any value attributed to items of IRD owned by the partnership.[951] 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

944. *See generally* I.R.C. § 708(b)(2)(B) (2012) (stating the current rule for division of a partnership).
945. *See id.*
946. *See id.*
947. *Id.* §§ 734, 743.
948. *Id.* § 755.
949. *Id.* § 754.
950. *See* Manning & Hesch, *supra* note 337.
951. *See* Treas. Reg. § 1.742-1 (1960).

> any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent . . . .[952]

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.[953] 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.[954]

2. *Inside Basis Adjustments at Death*

If a section 754 election is timely made or in place at the time of a partner's death, the estate or successor to the partnership interest gets the benefit of an inside basis adjustment over the partnership's assets under section 743.[955]

The inside basis adjustment will not, however, step-up the basis of partnership assets that would be considered IRD if held by the deceased partner individually and unrealized receivables of the partnership.[956]

The IRS has affirmatively ruled that the inside basis adjustment applies to the entire partnership interest that is considered community property upon the death of the deceased spouse or partner.[957]

The inside basis adjustment is limited by the fair market value of the deceased partner's interest in the partnership.[958] As such, to the extent that valuation discounts are applicable to the partnership interest, the inside basis adjustment will be limited to the extent of those discounts.[959] To the extent little or no transfer taxes would be payable upon the death of a partner, practitioners may want to reduce or eliminate such valuation discounts, thereby maximizing the inside basis adjustment with a section 754 election.[960] Further, because the inside basis adjustment under section 743 is applied to all of the assets in the partnership at the time of the death of the partner, the adjustment does not allow a tax practitioner to proactively choose which asset will get the benefit of the step-up in basis.[961] For this reason,

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952. *Id.*
953. *See* I.R.C. § 743(a); Treas. Reg. § 1.743-1 (as amended in 2004).
954. *See* Carol Cantrel, *Income Tax Problems When the Estate or Trust Is a Partner*, BRIGGS & VESELKA CO., http://bvccpa.com/wpcontent/uploads/2011/02/income_tax_problems_when_the_estate_or_trust_is_a_partner.pdf (last visited Oct. 25, 2014).
955. *See* I.R.C. § 743.
956. *Id.* §§ 1014(c), 691(a)(1); Woodhall v. Comm'r, 454 F.2d 226 (9th Cir. 1972); Treas. Reg. § 1.691(a)-1(b) (as amended in 1965).
957. *See* Rev. Rul. 79-124, 1979-1 C.B. 224.
958. *See* I.R.C. § 1014(a)(1).
959. *See id.*
960. *See* Todd I. Steinberg et al., *Death of a Partner and § 754 Elections: Income Tax Traps*, 31 TAX MGMT. EST. & TR. J. 1 (2006), *available at* http://www2.gtlaw.com/pub/articles/2006/steinbergt06a.pdf.
961. *See id.*

practitioners may want to consider distributing certain property in-kind to the partner prior to the partner's death and allowing the partner to own the property outside the partnership at the time of death; consequently, valuation discounts will not apply, and if the partner's outside basis is very low, the distributed property will have a very low basis in the hands of the partner.[962] In this manner, practitioners can maximize the size of the step-up in basis and also choose the asset that they wish to receive the basis adjustment at death.[963]

As mentioned above, the adjustment under section 743(b) is the difference between the successor partner's tax basis in partnership interest (generally, fair market value at the date of death under section 1014(a), increased by the partner's share of partnership liabilities and reduced by items of IRD), and the successor partner's proportionate share of the basis of the partnership property.[964] In calculating the partner's proportionate share of the partnership's tax basis, the Treasury regulations assume a fully taxable hypothetical sale of the partnership's assets.[965] This taxable sale is deemed to occur immediately after the transfer that triggers the inside basis adjustment.[966] The IRS has ruled that the transfer in question, for purposes of section 743(b), is the date of the decedent partner's death.[967] As such, practitioners should consider what effect the death of the partner might have on the value of the partnership assets in determining the inside basis adjustment.[968]

As mentioned above, even absent a section 754 election, there is a mandatory downward inside basis adjustment if, at the time of death, the partnership has a substantial built-in loss (more than $250,000).[969]

3. *Section 732(d) Election: Avoiding the Section 754 Election*

As mentioned above, even with no section 754 election, the estate or successor in interest can achieve the same benefits of an inside basis adjustment if the partnership makes a liquidating distribution of property within two years of the date of death, and if the successor partner makes an election under section 732(d).[970] The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable.[971] If the distribution does not include such property, the election can wait until the first year basis has tax significance.[972]

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962. *See* Cantrel, *supra* note 954.
963. *See id.*
964. *See* I.R.C. §§ 743(b), 1014(a).
965. *See* Treas. Reg. § 1.743-1(a) (as amended in 2004).
966. *See id.*
967. *See* Rev. Rul. 79-84, 1979-1 C.B. 223 (discussing that the partnership interest is owned by the grantor trust).
968. *See* Cantrel, *supra* note 954.
969. *See* I.R.C. § 743(b).
970. *See* Treas. Reg. § 1.732-1(d)(1)(iii).
971. *See id.* § 1.732-1(d)(2).
972. *Id.*

The basis adjustment is computed under section 743(b), which relates the basis adjustments due to sales or transfer of partnership interest (during the partners' lifetime, or more notably for this discussion, at his death).[973] 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.[974] In other words, the adjustment is allocated to all of the partnership property whether actually distributed or not.[975] If any property for which the distributee or 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.[976]

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.[977] As mentioned above, once the section 754 election is made, it is irrevocable unless the IRS gives permission to revoke the election.[978] The inside basis adjustments under section 743(b) only apply to the transferees of the partnership interests (not to the partnership as a whole); therefore, having a section 754 election in place requires having a different set of basis calculations for the transferees of the interest.[979] The bookkeeping requirements become quite onerous as partnership interests are often distributed at death to multiple trusts or beneficiaries and become even more onerous as additional partners pass away.[980]

If the distribution of property is made pursuant to a 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 that the value of the partner's interest, for purposes of section 1014(a), should not entail valuation discounts.[981] This would, in turn, increase the inside basis adjustment on the assets claimed with the section 732(d) election.[982] 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

973. *See* I.R.C. § 743(b).

974. *See* Steinberg, *supra* note 960.

975. Treas. Reg. §§ 1.732-1(d)(1)(vi), 1.743-1(g)(1), (5), ex. (ii).

976. *Id*. § 1.743-1(g)(2), (5), ex. (iv).

977. *See* Grace Kim & Jose Carrasco, *Don't Forget the Mandatory Application of Sec. 732(d),* AM. INST. CPAS (Feb. 1, 2014), http://www.aicpa.org/Publications/TaxAdviser/2014/february/Pages/clinic-story-07.aspx.

978. Katy Shubert, *Partnerships and LLCs: The Basics of Making a 754 Election*, MARCUM (Aug. 5, 2013), http://www.marcumllp.com/news-and-events/partnerships-and-llcs-the-basics-of-making-a-754-election.

979. *See generally* I.R.C. §§ 732, 743, 754 (2012) (demonstrating the requirement of different calculations for transferees).

980. *See generally id.* §§ 732, 743, 754.

981. *See generally id.* § 1014 (demonstrating the requirement that the estate could make).

982. *See generally id.* § 732(d).

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 obtain 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.

I. Maximizing the "Step-Up" and Shifting Basis

Given the limitations of the basis adjustment at death, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner's death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply at the partners' death, and if the partner's outside basis is very low, the distributed property will have a very low basis in the hands of the partner.[983] In this manner, practitioners can maximize the size of the step-up in basis and also choose the asset that they wish to receive the basis adjustment at death.[984]

Consider the following scenario: FLP owns two assets, one with a very high basis and one with a very low basis, neither of which is a marketable security. The assets have been in the FLP for more than seven years. The partners consist of younger family members and a parent. Assume that the parent's outside basis in the FLP is zero. As discussed above, the traditional advice of allowing the parent to die with the FLP interest and making a section 754 election after death will likely create an inside basis adjustment that is limited by a significant valuation discount under section 743.[985] Assume further that the partnership intends on selling the very low basis asset relatively soon. What might be a way to maximize the step-up in basis that will occur at the parent's death and also create tax basis for the low basis asset that will be sold? The partnership should make a section 754 election and distribute the high basis asset in-kind to the parent in full or partial liquidation or redemption of the parent's interest in the partnership.[986] What is the result of this distribution?

Because the distribution is not cash or marketable securities, neither the partner nor the partnership will recognize any gain or loss upon a distribution of the property.[987] In addition, because the assets have been in the

983. *See id.* § 1014(a)(1).
984. *See id.*
985. *See supra* Part V.H.2.
986. Treas. Reg. § 1.754-1 (as amended in 2000).
987. *See* I.R.C. § 731(a)–(b); Treas. Reg. § 1.731-1(a)–(b) (1960). This assumes the property distributed is not a "hot-asset" under section 751. *See* I.R.C. § 751 (2012).

partnership for more than seven years, there are no concerns about triggering any gain to another partner under the mixing bowl or the disguised sale rules.[988] The basis of the distributed property in the hands of the parent is based on the tax basis that the partnership had in the property prior to the distribution.[989] However, the basis of the distributed property will be limited to the outside basis of the partner's partnership interest, as adjusted for cash distributions, reduction in basis, and changes in liabilities, because the distributed property is encumbered with debt.[990] This limitation effectively transfers the inherent gain in the partnership interest, which is outside basis, to the distributed property.[991] In other words, the basis of the asset now held by the parent is zero.[992] Because the parent now owns the property individually and outside of the partnership, upon the parent's death, the property will get a full step-up in basis to fair market value, free of any valuation discounts.[993]

Because a section 754 election was made, an adjustment of inside basis under section 734(b) occurs.[994] The adjustment results in an increase to the inside basis of the partnership assets.[995] The increased basis adjustment is first allocated to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class (capital gain or ordinary) in proportion to fair market values.[996] Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners.[997] The result, in this case, is the tax basis that was "stripped" from the high basis asset when it was distributed to the parent (and became a zero basis asset) is allocated to the only other remaining asset in the partnership, the low basis asset that will be sold.[998] Thus, the low basis asset becomes a high basis asset, reducing or eliminating the gain recognized when the asset is sold.[999] Unlike adjustments under section 743(b), adjustments under section 734(b) (upon a distribution of partnership property to a partner) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership, not just for the benefit of a transferee.[1000]

The type of basis management discussed above is predicated upon a number of factors that must be orchestrated well in advance of the actual

988. *See* Akers, *supra* note 129.
989. *See id.*
990. *See id*.
991. *See id.*
992. I.R.C. § 732(a) (2012).
993. *See* Akers, *supra* note 129.
994. I.R.C. § 736 (2012).
995. *See id.*
996. *Id.* § 755.
997. *See* Akers, *supra* note 129.
998. *See id.*
999. *See id.*
1000. *See* I.R.C. §§ 734(b), 763(b) (2012).

transaction.[1001] In particular, the movement of tax basis and the maximization of the step-up is predicated upon: (i) the selective use of the section 754 election, not necessarily at death but certainly upon distribution of assets in-kind; (ii) the isolation of the assets used in the basis shift; (iii) the avoidance of triggering gain under the mixing bowl and disguised sale rules; and (iv) the manipulation of outside basis, so that the partner to receive the property has zero or very low basis in the partnership interest.[1002] As such, planners should consider evolving the partnership over time to put the taxpayers in the best position to take advantage of the type of flexibility that the partnership rules allow.[1003]

By way of example, practitioners should consider setting up a partnership funded with all manner of assets used in this type of planning, such as high and low basis assets, depreciable and non-depreciable assets, closely held company interests, cash, etc.[1004] The more assets the taxpayers contribute, the more options are available in the future.[1005] The only type of asset planners should consider avoiding is marketable securities because a distribution consisting of marketable securities is generally treated as a distribution of cash, rather than property.[1006] Thus, regardless of the basis in the marketable securities, a distribution may cause the distributee partner to recognize gain because of insufficient outside basis.[1007] However, as discussed later, there is an important exception to this rule that might allow practitioners to create a separate partnership holding only marketable securities and still allow the types of tax basis management discussed herein.[1008] Once the assets have been contributed, it is critical that the assets remain in the partnership for at least seven years to avoid the mixing bowl and disguised sale rule problems.[1009]

As discussed in more detail above, distributions of marketable securities are generally treated as cash.[1010] However, an important exception to this rule exists for distributions of securities from an "investment partnership" to an "eligible partner."[1011] An investment partnership is defined as a partnership in which substantially all of the assets consist of specified investment-type assets and that has never been engaged in a trade or business.[1012] 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

1001. *See* Akers, *supra* note 129.
1002. *See id*
1003. *See id.*
1004. I.R.C. § 751 (2012).
1005. *See id.*
1006. *Id.* § 731(c).
1007. *See id.*
1008. *See infra* Part V.J.
1009. *See* Akers, *supra* note 129.
1010. I.R.C. § 751.
1011. *Id.* § 731(c)(3)(C)(i), (c)(3)(A)(iii).
1012. *Id.* § 731(c)(3)(C)(i).

(6) derivative financial instruments (including options, forward or futures contracts, and short positions).[1013] An eligible partner is one who, before the date of distribution, did not contribute any property to the partnership other than specified investment-type assets permitted to be held by an investment partnership.[1014] As such, if taxpayers wish to proactively manage the basis of marketable securities in the manner discussed in this article, taxpayers must have a partnership that, from inception, has essentially only held marketable securities and has never engaged in a trade or business.[1015] Hence, practitioners should consider having taxpayers create partnerships that only hold marketable securities for at least seven years.[1016]

During the seven year period, if at all possible, the partnership should avoid making a section 754 election because of the limitations of the inside basis adjustment at death and the onerous record keeping requirements discussed above.[1017] Once the seven year period has expired, then the assets of the partnership, hopefully free of a section 754 election, are ripe for proactive tax basis management.[1018] Once an opportunity arises for the type of planning discussed above (e.g., a potential sale of a low basis asset or the failing health of a partner), then the partnership can proceed to isolate the appropriate assets in a tax free "vertical slice" division.[1019] The assets carved out of the larger partnership into a smaller partnership will become the assets selected to receive the basis and will have their basis reduced upon distribution.[1020] The planner should give careful consideration to reducing the outside basis of the distributee partner through disproportionate distributions of cash or shifting basis to other partners by changing the allocable share of partnership debt under section 752 (e.g., by converting nonrecourse debt to recourse debt through a guarantee by the other partners).[1021]

Upon distribution of the higher basis assets to the distributee partner, the inside basis adjustment will apply across all of the remaining assets in the partnership, but only those assets spun off the larger partnership are in this partnership.[1022] Thus, this allows for a larger basis increase to those assets, rather than having the basis increase apply to all of the assets of the larger partnership and never creating an asset fully flush with tax basis.[1023] A section 754 election is required to effectuate the inside basis shift under section 734, but the election will only apply to the smaller, isolated partnership.[1024] As

1013. *Id.* § 731(c)(3)(C)(i)(I)–(VIII).
1014. *Id.* § 731(c)(3)(C)(iii)(I).
1015. *See id.*
1016. *See* Akers, *supra* note 129.
1017. I.R.C. § 734 (2012).
1018. *Id.*
1019. Joe Walsh, *New Proposed Regulations on Built-in-Losses*, 93 PRAC. TAX STRATEGIES 3, 6 (2014).
1020. *See id.*
1021. *See* Treas. Reg. § 1.752-2(b) (as amended in 2006).
1022. *See* Walsh, *supra* note 1019, at 8.
1023. *See id.*
1024. *See id.*

such, the record keeping requirements are kept to a minimum and are totally eliminated when, and if, the smaller partnership is dissolved and liquidated.[1025] Remember, in a vertical slice division, the isolated partnership is considered a continuation of the larger partnership, and the elections of the previous partnership follow to the new partnership.[1026] Keeping the larger partnership free of a section 754 election allows practitioners to selectively choose when and over what assets a section 754 will apply in the future.[1027]

J. Family Partnership Examples

1. Example 1: Indemnifications and Divisions

The following hypothetical illustrates how easily partnerships can facilitate tax basis management in fairly typical estate planning scenarios. The facts are as follows:

(1) Assume that Mr. and Mrs. Developer are married with three adult children. Exclusive of their home, vacation home, and other personal use assets, Mr. and Mrs. Developer have a net worth of approximately $25 million. Most of Mr. and Mrs. Developer's wealth derives from constructing, owning, and leasing "General Dollar" stores across Georgia—a state that does not have a state death tax. All of the General Dollar store properties are held by General Dollar Lessor, LLC, which is a wholly-owned subsidiary of Mr. and Mrs. Developer's family partnership, "Developer Family Partnership, LLLP" (hereinafter FLLLP). Assume General Dollar Lessor, LLC has no assets other than the General Dollar stores that it owns and leases. FLLLP was formed many years ago to be the family "holding company."[1028]

(2) General Dollar Lessor, LLC has a gross fair market value of approximately $31 million subject to recourse debt of $10 million, which is secured by all of its assets, for a net value of $21 million. Mr. Developer personally guaranteed the debt. Due to depreciation and past like-kind exchanges, the adjusted basis of the assets held by General Dollar Lessor, LLC is only $10 million.

(3) FLLLP owns $9 million in publicly traded securities in addition to its ownership of 100% of General Dollar Lessor, LLC. Essentially, the $9 million in publicly traded securities was accumulated by investing cash flow and earnings distributed to FLLLP from General Dollar Lessor, LLC. In turn, FLLLP would distribute some of the cash flow and earnings to its

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1025. *See id.*
1026. *See id.*
1027. I.R.C. § 754 (2012).
1028. If the FLLLP has been in existence for more than seven years and the partners have not contributed appreciated or depreciated property to the FLLP within the past seven years, then the FLLLP will avoid the "mixing bowl" and "disguised sale" rules of sections 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b). *See id.* §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, 751(b).

partners, especially for them to pay taxes, but FLLLP would retain and invest any amounts not distributed to its partners. The aggregate adjusted basis of the FLLLP in the publicly traded securities is $6 million. A significant portion of the securities have bases equal to their face values (e.g., bonds).

(4) The aggregate outside bases of the partners of FLLLP in their partnership interests is $16 million. The ownership of FLLLP is split roughly 70% to Mr. Developer and 30% to his three adult children as follows:

(a) Mr. and Mrs. Developer own 50% each in FLLLP GP, LLC, which in turn owns a 1% general partner interest in FLLLP. The outside basis of FLLLP GP, LLC in its GP interest in FLLLP is $203,000 (rounded). The non-discounted value of FLLLP GP, LLC's 1% GP interest in FLLLP is $300,000.

(b) Mr. Developer owns 69 limited partner "LP Units." These LP Units correspond to an aggregate 69% interest in FLLLP (1% per LP Unit). Mr. Developer's LP Units have a total outside basis of $13,997,000 (rounded) and a non-discounted value of $20,700,000.

(c) Each adult child owns 10 LP Units (corresponding to a 10% interest in FLLLP for each child). Each child's outside basis in their LP Units is $600,000 and the non-discounted value of each child's 10 LP Units is $3 million, respectively.

(5) Mr. and Mrs. Developer have their full $10.68 million applicable credit available, and have a basic estate plan that leaves all of their assets to their three adult children and their families.

(6) Based upon the foregoing facts, the capital accounts and bases of Mr. and Mrs. Developer and their children in their partnership interests (their outside bases) in FLLLP are shown in the table below:[1029]

	Developer (Includes Family GP, LLC)			Children		
	Capital Accounts	Outside Basis	Fair Market Value	Capital Accounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000

The Treasury regulations treat the $10 million debt of General Dollar Lessor, LLC as partner nonrecourse debt with respect to Mr. Developer.[1030] The debt receives treatment as partner nonrecourse debt because Mr.

1029. Treasury Regulation section 1.704-1(b)(2)(iv) contains the rules regarding the maintenance of capital accounts for partners in a partnership. Treas. Reg. § 1.704-1(b)(2)(iv) (as amended in 2013). I.R.C. section 705 and the Treasury regulations thereunder contain the rules regarding the determination of a partner's basis in his or her partnership interest. I.R.C. § 705 (2012). For the sake of simplicity, the capital accounts and outside bases of Mr. and Mrs. Developer and the children are aggregated here (including, of course, the capital accounts and outside bases of Mr. and Mrs. Developer held through Family GP, LLC).

1030. *See* Treas. Reg. § 1.704-2(b)(4) (as amended in 2011).

Developer guaranteed it and, therefore, bears the economic risk of loss with respect to the loan if, as the Treasury regulations require one to assume, General Dollar Lessor, LLC's assets became worthless and the liability became due.[1031] Accordingly, the regulation treats the debt of General Dollar Lessor, LLC as recourse to Mr. Developer.[1032] Therefore, Mr. Developer receives the entire $10 million of the liability for purposes of determining his outside basis in FLLLP.[1033] This is why Mr. Developer's aggregate outside basis in FLLLP ($14.2 million) is disproportionately higher than the aggregate outside basis ($1.8 million) of the children in FLLLP.[1034]

Assume that Mrs. Developer predeceases Mr. Developer and leaves all of her assets to him. Next, Mr. Developer dies leaving all of his partnership interests in FLLLP to his three adult children in equal shares. Further, assume for this purpose that Mr. Developer's combined partnership interests in FLLLP have a non-discounted value of $20 million.[1035] If Mr. Developer discounts his combined partnership interests in FLLLP by 25% for estate tax purposes, then their value will be $15 million (75% of $20 million).[1036] This discounted estate-tax value results in very little step-up in outside basis in the FLLLP as compared to Mr. Developer's pre-death outside basis of $14.2 million.[1037]

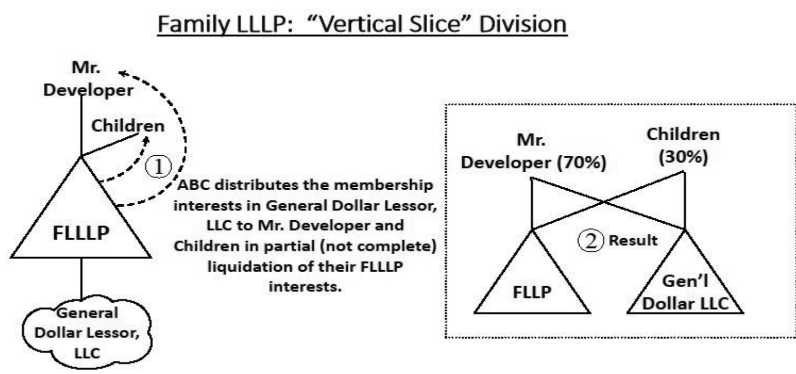
On the other hand, if prior to his death Mr. Developer's children had indemnified Mr. Developer for 30% (i.e., their combined percentage share of FLLLP) of any liability on the $10 million debt of General Dollar Lessor, LLC, then the outside bases of Mr. Developer and his children in FLLLP would have looked similar to the figures in the table below.[1038]

	Developer (Includes Family GP, LLC)			Children		
	Capital Accounts	Outside Basis	Fair Market Value	Capital Accounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000
Children Indemnify 30% Debt		($3,000,000)			$3,000,000	
TOTALS	$4,200,000	$11,200,000	$21,000,000	$1,800,000	$4,800,000	$9,000,000

1031. *See id.*
1032. *See id.* § 1.752-1(a)(1) (as amended in 2005).
1033. *See id.* § 1.752-2 (as amended in 2006).
1034. *See id.*
1035. That is, his 69% limited partner interest held directly in FLLLP and his 1% general partner interest held through Family GP, LLC.
1036. *See id.* § 1.753-1 (1960).
1037. *See id.*
1038. *See id.* §§ 1.752-1, 1.752-2; *see also* I.R.C. § 752(a)–(b) (2012) (describing the shift in liability as a constructive distribution of cash).

Under the Treasury regulations, this simple step of indemnifying Mr. Developer for 30% of the $10 million debt—a step contemplated by the Treasury regulations[1039]—would shift a debt allocation of $3 million of the $10 million General Dollar Lessor, LLC debt to the children.[1040] This shift would not change the percentage interests of the partners or the values of their partnership interests.[1041] As noted above, though, the shift would clearly increase the amount of the potential basis step-up to Mr. Developer's estate by $3 million upon his death, even after taking into account the estate tax valuation discount on Mr. Developer's partnership interests in FLLLP.[1042]

Moreover, Mr. Developer could take proactive tax basis management a step further if, prior to his death, the FLLLP implemented a vertical slice partnership division under section 708(b)(2)(B) (an assets-over transaction, as discussed above).[1043] Specifically, a vertical slice division of FLLLP would involve a pro rata distribution by the FLLLP of the membership interests in General Dollar Lessor, LLC to Mr. Developer and his children.[1044] The marketable securities would remain within the FLLLP, while the real estate assets would remain within General Dollar Lessor, LLC.[1045] The diagram below illustrates such a division.



1039. *See* Treas. Reg. §§ 1.752-1(a)(1), 1.752-2(b)(3) (stating that parties should consider contractual obligations "such as . . . indemnifications" outside the partnership agreement when determining the partners' economic risk of loss and shares of liabilities for outside basis purposes).

1040. Technically, Code sections 752(a) and 752(b) treat this shift in the allocation of the $10 million debt of General Dollar Lessor, LLC as a constructive distribution of cash to Mr. Developer and a constructive contribution of cash by the children, thereby decreasing and increasing, respectively, their outside basis. *See* I.R.C. § 752(a)–(b) (2012). Because the IRS treats the shift as a constructive distribution of cash to Mr. Developer, the advisor must keep in mind section 731(a)(1), which provides that a distribution of cash (constructive or otherwise) from a partnership to a partner that exceeds the partner's outside basis results in a gain to that partner. *See id.* § 731(a)(1). Here, though, the $3 million constructive distribution is far less than Mr. Developer's outside basis.

1041. *See id.* § 731.

1042. *See id.* § 752(a)–(b); Treas. Reg. §§ 1.752-1, 1.752-2.

1043. *See generally* I.R.C. § 708(b)(2)(B) (2012) (providing that a division of a partnership results in a continuation of the partnership for tax purposes).

1044. *See id.* § 704.

1045. *See id.* § 731.

Thus, as a result of a vertical slice division of FLLLP, Mr. Developer and his children would own 70%/30%, respectively, of two separate partnerships: the FLLLP, which would own $9 million in securities, and General Dollar Lessor, LLC, which would own $31 million in real estate subject to a debt of $10 million.[1046] As discussed above, this type of vertical slice division of FLLLP would not run afoul of the mixing bowl or disguised sale rules.[1047]

Significantly, the partnership division would also avoid the special rule of section 731(c) that treats a distribution of marketable securities as a distribution of cash.[1048] This is because the division does not involve a distribution of the securities.[1049] Otherwise, under section 731(c), a distribution of marketable securities with a fair market value in excess of a partner's outside basis can trigger gain to the partner.[1050]

The effect of a vertical slice division on the capital accounts and outside bases of Mr. Developer and his children, with respect to FLLLP and General Dollar Lessor, LLC, are set forth below.[1051]

	Developer (Includes Family GP, LLC)			**Children**		
P'ship Division—FLLLP	**Capital Accounts**	**Outside Basis**	**Fair Market Value**	**Capital Accounts**	**Outside Basis**	**Fair Market Value**
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000
Spin Out Gen'l Dollar Lessor	$0	($10,000,000)	($14,700,000)	$0	$0	($6,300,000)
TOTALS	$4,200,000	$4,200,000	$6,300,000	$1,800,000	$1,800,000	$2,700,000

General Dollar Lessor, LLC	**Capital Accounts**	**Outside Basis**	**Fair Market Value**	**Capital Accounts**	**Outside Basis**	**Fair Market Value**
Initial Balances	$0	$10,000,000	$14,700,000	$0	$0	$6,300,000
Children Indemnify 30% Debt		($3,000,000)			$3,000,000	
TOTALS	$0	$7,000,000	$14,700,000	$0	$3,000,000	$6,300,000

With the marketable securities and real estate assets now segregated, upon Mr. Developer's death, the discount taken with respect to the estate's partnership interest in FLLLP might be less, thus facilitating a higher step-up in basis in the securities.[1052] The estate's partnership interest in General Dollar

1046. *See id.* §§ 704, 731.
1047. *See supra* Parts V.D.3–4.
1048. *See* I.R.C. § 731(c).
1049. *See id.*
1050. *Id.* § 731(a)(1).
1051. *See id.* §§ 704, 731.
1052. *See generally id.* § 1014 (describing the step-up in basis rule).

Lessor, LLC would be subject to a significant discounting, but indemnification of Mr. Developer by the children (as discussed above) could prevent the discount from effectively nullifying the benefit of the basis step-up.[1053]

2. Example 2: In-Kind Distributions and Section 754 Election

Partner indemnification of debt is not the only means to engage in tax basis management with partnerships.[1054] In the right circumstances, the estate planning advisor should consider in-kind distributions of property from a family partnership to one or more partners.[1055]

Consider the following hypothetical situation: Assume that ABC Family, LLC owns raw land held for long-term investment. A has a 33.34% interest in ABC Family, LLC, while each of A's adult children, B and C, have a 33.33% interest in ABC Family, LLC. Each member of ABC Family, LLC has an outside basis in his membership interest of $1.5 million.

Assume further that the raw land held by ABC Family, LLC remains unencumbered and consists of the following three parcels of land: Parcel 1 has an adjusted basis of $4 million but a value of only $2 million; Parcels 2 and 3 each have an adjusted basis of $250,000 and a value of $5 million. Thus, ABC Family, LLC is worth a total of $12 million and has an aggregate adjusted basis of $4.5 million in the land. Each member's interest in ABC Family, LLC, therefore, is worth $4 million before taking into account any valuation discounts. Notice as well that the aggregate inside basis of ABC Family, LLC in the raw land ($4.5 million) is equal to the aggregate outside basis (3 x $1.5 million = $4.5 million) of the members of ABC Family, LLC.[1056] Further, assume that all capital contributions to ABC Family, LLC are outside the seven year prohibition such that the mixing bowl and disguised sale rules are not implicated.[1057]

a. Section 754 Election and Tax Basis Management

Assume that A dies leaving his entire 33.34% membership interest in ABC Family, LLC to his children, B and C. Assume that A's membership interest has an outside basis of $1.5 million and a value of $4 million at

1053. *See id.* § 1014(e)(2)(B).

1054. *See id.* § 731.

1055. *See id.*

1056. Typically, absent the death of a partner or a sale or exchange of a partner's partnership interest, the aggregate inside basis of a partnership in its property will equal the aggregate outside basis of the partners in their partnership interests. *See id.*

1057. If ABC Family, LLC has been in existence for at least seven years, and no appreciated or depreciated property has been contributed to ABC Family, LLC by the partners within the past seven years, then ABC Family, LLC will avoid the "mixing bowl" and "disguised sale" rules of sections 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b). *See id.* §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, 751(b).

the time of A's death.[1058] ABC Family, LLC typically would make a section 754 election to optimize the estate's step-up in basis in A's membership interest.[1059] Pursuant to section 743(b), the election allows A's estate, which ultimately benefits B and C, to adjust its proportionate share of ABC Family, LLC's inside basis in the land by a net amount of $2.5 million (i.e., an amount equal to the outside basis step-up in A's membership interest from $1.5 million to $4 million).[1060]

It is important to understand that the adjustment under section 743(b) is personal to the transferee partner (A's estate, and ultimately B and C).[1061] The adjustment is thus made to the transferee's (the estate's) *share of the inside basis* of the partnership in its property, not the partnership's basis in the property itself.[1062] In the case of ABC Family, LLC, the estate's share, as well as B's and C's respective shares, of the inside basis of the partnership in the land is as follows: Parcel 1 equals $1.334 million, one-third of inside basis of $4 million, and Parcels 2 and 3 equal $83,334, one-third of inside basis of $250,000 in each parcel.[1063]

Next, under section 755, the amount of the adjustment under section 743(b) ($2.5 million) must be allocated among the individual items of ABC Family, LLC's property.[1064] The adjustment to the basis of items of partnership property is determined by reference to what would be the allocation of gains and losses to the transferee partner (A's estate) from a hypothetical sale of the partnership's property.[1065] Moreover, the allocation of the adjustment across items of partnership property is made by reference to the net amount of the adjustment.[1066] Therefore, some items of partnership property, such as built-in loss property, may be subject to a negative adjustment while other items of partnership property, such as built-in gain property, are subject to a positive adjustment.[1067]

If, in a hypothetical sale, after A's death, ABC Family, LLC sold all of its property for its then fair market value, the gain and loss from such a sale would be allocated to A's estate as follows: $1.583 million gain (one-third of the built-in gain of $4.75 million ($5 million less adjusted basis of $.25 million)) from both Parcels 2 and 3, and $.667 million loss (one-third of the $2 million built-in loss) from Parcel 1.[1068] Accordingly, the $2.5 million net adjustment

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1058. *See supra* Part V.J.2. For the sake of simplicity, this example assumes no discounted value on the 33.34% membership interest held by A's estate. Even if A's membership interest is subject to a valuation discount, however, the same principles illustrated here apply.

1059. I.R.C. § 754 (2012).

1060. *See* Treas. Reg. § 1.743-1(b) (as amended in 2004).

1061. I.R.C. § 743(b) (2012).

1062. *See id.* (noting the flush language).

1063. *See supra* Part V.J.2 (stating the parcel's inside basis).

1064. I.R.C. § 755 (2012).

1065. Treas. Reg. § 1.755-1(b)(1)(ii) (as amended in 2004).

1066. *Id.*

1067. *Id.* § 1.755-1(b)(1).

1068. *See* I.R.C. §§ 743(b), 755.

under section 743(b) for the estate with respect to ABC Family, LLC is allocated as follows:

(a) decrease the estate's share of inside basis in Parcel 1 to $.667 million (i.e., the estate's pre-adjustment share of inside basis of $1.334 million attributable to Parcel 1 less the estate's $.667 million allocable share of loss on a hypothetical sale); and

(b) increase the estate's share of inside basis in Parcels 2 and 3 to $1.667 million each (i.e., the estate's pre-adjustment share of inside basis of $83,334 per parcel plus the estate's $1.583 million per parcel allocable share of gain from a hypothetical sale).[1069]

The ultimate goal of these complicated adjustments is to ensure that if ABC Family, LLC sold all of its assets for their fair market values at the time of A's death, the estate would benefit from the step-up in basis and (on a net basis) would not be allocated gain or loss from the sale.[1070] And, if we re-examine the facts of our hypothetical, we see that by virtue of the adjustments under section 743(b) this result is, in fact, produced.[1071] In particular, the estate's inside share of basis with respect to Parcels 1 and 2 has been adjusted to $1.667 million each.[1072] Thus, if Parcels 1 and 2 sell for their respective fair market values of $5 million each, the estate's one-third share of the proceeds from each parcel would be $1.667 million (one-third of $5 million), exactly equal to the estate's adjusted share of inside basis per parcel.[1073] Thus, the estate will recognize no gain or loss with respect to the sale of either Parcel 1 or 2. Likewise, if Parcel 1 sold for its fair market value of $2 million, the estate's share of the proceeds would be $.667 million (one-third of $2 million), exactly equal to the estate's adjusted share of inside basis with respect to Parcel 1. Again, no gain or loss will be recognized by the estate with respect to the sale of Parcel 1.

b. Benefits to B and C as A's Heirs

If we now examine ABC Family, LLC from the perspective of B and C (the heirs to A's estate) we see that, on balance, the step-up in basis, the section 754 election, and the corresponding adjustments under section 743(b) benefit B and C. B and C benefit because $2.5 million of built-in gain within ABC Family, LLC that would have been allocable to A prior to his death is now offset by the net $2.5 million adjustments made to Parcels 1, 2, and 3.[1074]

1069. *See id.*
1070. *See id.*
1071. *See id.*
1072. *See generally id.* (demonstrating the application of the statute to the hypothetical).
1073. *See generally id.* (demonstrating the application of the statute to the hypothetical).
1074. *See id.* §§ 754, 743. More specifically, B's and C's shares of inside basis in ABC Family, LLC's property were $1.334 million each in Parcel 1 and $83,334 each in Parcels 2 and 3 prior to A's death. Without the section 754 election and the corresponding adjustments under section 743(b), B's and C's

Upon closer examination, however, we also see that the result of the $2.5 million net adjustment is not entirely beneficial to B and C. First, there is no question that B and C benefit from the positive adjustment attributable to the estate's share of inside basis in Parcels 2 and 3. The adjustment reduces the taxable gain that B and C will report from a sale of either Parcel 2 or 3 by ABC Family, LLC.[1075] On the other hand, the negative adjustment to the estate's share of inside basis in Parcel 1 is unfavorable. This negative adjustment reduces the amount of loss that B and C would report from a sale of Parcel 1 by ABC Family, LLC had the section 754 election not been made.[1076]

Put differently, the section 754 election and corresponding adjustments apply across every item of partnership property.[1077] There is no ability to pick and choose which assets to adjust so that built-in gain is reduced while built-in loss is preserved.[1078] Nonetheless, ABC Family, LLC perhaps could have distributed the built-in loss property, Parcel 1, to A in partial redemption of A's 33.34% membership interest in order to better optimize the favorable aspects of the section 754 election.[1079]

c. Distributing Loss Property to Optimize Section 754 Election

Under section 731, a current (i.e. non-liquidating) in-kind distribution of property (other than money) to a partner generally does not result in the recognition of gain or loss to the partnership or to the distributee partner.[1080] Instead, the distributee partner takes a basis in the property equal to, but not in excess of, the distributing partnership's basis, and the distributee partner reduces his outside basis in his partnership interest by an amount equal to his basis in the distributed property.[1081] Moreover, if the distributing partnership makes (or has in effect) a section 754 election and the distributed property had

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shares of inside basis simply would have reflected their inherited portions of A's inside basis prior to his death; B's and C's share of inside basis in Parcel 1 would have been $2 million each ($1.334 million plus $.666 million, which is one-half of A's former share ($1.334 million) of inside basis in Parcel 1); and B's and C's respective shares of inside basis in Parcels 2 and 3 would have been $.125 million each ($83,334 plus $41,666, one-half of A's former share ($83,334) of inside basis in each of Parcels 2 and 3).

By virtue of sections 754 and 743(b), however, B's and C's shares of inside basis in Parcels 1, 2, and 3 are as follows: B's and C's respective shares of inside basis in Parcel 1 are lower—$1.667 million each ($1.334 million plus $.3335 million, one-half of the estate's adjusted share ($.667 million) of inside basis in Parcel 1); B's and C's respective shares of inside basis in Parcels 2 and 3 are higher—$.9175 million each ($83,334 plus $.834 million, one-half of the estate's adjusted share ($1.667 million) of inside basis in each of Parcels 2 and 3).

1075. *See generally id.* (demonstrating the application of the statute to the hypothetical).

1076. *See generally id.* (demonstrating the application of the statute to the hypothetical).

1077. *See id.* § 754.

1078. *See id.*

1079. *See id.*

1080. *Id.* § 731(a)–(b). Under section 731(c), though, an in-kind distribution of marketable securities can be treated as a distribution of money triggering gain (but not loss) to the distributee partner. *Id.* § 731(c).

1081. *Id.* §§ 732(a), 733.

a basis in the partnership's hands higher than the distributee partner's outside basis in his partnership interest, then the excess results in a positive adjustment under section 734(b) to the distributing partnership's basis in its remaining assets.[1082] Unlike the adjustments under section 743(b) (e.g., arising upon the death of partner), the adjustment under section 734(b) is not personal to the distributee partner.[1083] Instead, where it applies, section 734(b) creates an upward or downward adjustment in the partnership's basis in its remaining property.[1084] Then, under section 755, the adjustment under section 734(b) is allocated across the partnership's remaining property according to unrealized appreciation or depreciation among classes and items of property, in accordance with the methodology set forth in the Treasury regulations.[1085]

If we apply these rules in the context of ABC Family, LLC and assume that Parcel 1, the built-in loss property, is distributed to A prior to his death, then we can produce a more favorable result to B and C, A's heirs, than is produced if Parcel 1 is not distributed and ABC Family, LLC makes a section 754 election upon A's death.[1086]

To wit, recall that ABC Family, LLC is worth \$12 million and that A, B, and C own membership interests in ABC Family, LLC worth \$4 million each, assuming no valuation discount.[1087] A, B, and C have an outside basis of \$1.5 million each in their membership interests. Parcel 1 is a built-in loss property with a basis of \$4 million and a value of \$2 million. Parcels 2 and 3 are each built-in gain properties with adjusted bases of \$20,000 each and values of \$5 million each.

Assume that ABC Family, LLC distributes Parcel 1 to A prior to his death in partial redemption of his membership interest and also makes a section 754 election. Under the rules of subchapter K, the taxpayer obtains the following results:

(a) Under sections 731 and 732, A takes Parcel 1 with a value of \$2 million and a basis of \$1.5 million, exactly equal to A's outside basis in his partnership interest.[1088]

(b) Under section 733, A's outside basis in his interest in ABC Family LLC is reduced to zero.[1089]

(c) A's percentage interest in ABC Family, LLC is reduced to 20% (because A is left with a membership interest worth \$2 million in a partnership worth \$10 million).[1090]

1082. *See id.* § 734(b).
1083. *See id.*
1084. *See id.*
1085. *See* Treas. Reg. § 1.755-1(c) (as amended in 2004).
1086. *Id.*
1087. *See supra* Part V.J.2 (providing the hypothetical). Again, for the sake of simplicity, this example assumes no discounted value.
1088. *See* I.R.C. §§ 731–32 (2012).
1089. *Id.* § 733.

(d) B's and C's percentage interests in ABC Family, LLC is increased to 40% each because they each have membership interests worth $4 million in a partnership worth $10 million.[1091]

(e) *Most importantly*, an adjustment under section 734(b) in the amount of $2.5 million arises from the distribution of Parcel 1 to A (e.g., $4 million inside basis in Parcel 1 less A's $1.5 million outside basis in his membership interest immediately prior to the distribution).[1092]

Then, under section 755, the $2.5 million adjustment under section 734(b) must be allocated across Parcels 2 and 3 in proportion to the unrealized gain in each parcel.[1093] The unrealized gain in each of Parcels 2 and 3 is the same: $4.75 million. ABC Family, LLC, therefore, increases its inside basis in Parcels 2 and 3 by $1.25 million each. This leaves ABC Family, LLC holding Parcels 2 and 3, worth $5 million each, with an inside adjusted basis of $1.5 million each, $.25 million plus $1.25 million.[1094]

Next, assume that A dies holding his 20% membership interest in ABC Family, LLC and Parcel 1. A's membership interest had a non-discounted value of $2 million and a basis of zero. Parcel 1 had a value of $2 million and a basis of $1.5 million. A's estate steps up its basis in the ABC Family, LLC membership interest from zero to $2 million.[1095] A's estate steps up its basis in Parcel 1 from $1.5 million to $2 million.[1096] Furthermore, under section 754, the $2 million step-up in the estate's outside basis in its membership interest in ABC Family, LLC gives rise to a $2 million adjustment under section 743(b).[1097] That $2 million positive adjustment increases the estate's, and ultimately B's and C's, share of inside basis in Parcels 2 and 3 by $1 million each.[1098] This $1 million positive adjustment under section 743(b) is in addition to the $1.25 million positive adjustment under section 734(b) that previously had been made to Parcels 2 and 3 as a result of the distribution of Parcel 1 to A.[1099]

Thus, B and C inherit from A, Parcel 1 with a value of $2 million and a basis of $2 million.[1100] There is no longer a trapped, built-in loss in Parcel 1.[1101] B and C also inherit from A his 20% interest in ABC Family, LLC, leaving B and C owning 50% each of ABC Family, LLC. However, due to

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1090. *See id.* As discussed above, non-pro rata distributions of property in family partnerships almost always should result in adjustment of the partners' percentage interests in the partnership. Otherwise, the special valuation rules of Chapter 14 will come into play. *See id.*

1091. *See id.* §§ 731–33.

1092. *See id.* § 734(b).

1093. *See id.* §§ 734(b), 755.

1094. *See id.* §§ 734(b), 755.

1095. *See id.* §§ 734(b), 755.

1096. *See id.* §§ 734(b), 755.

1097. *See id.* §§ 743(b), 754.

1098. *See id.* §§ 743(b), 754.

1099. *See id.* §§ 743(b), 734(b).

1100. *See id.* §§ 743(b), 734(b).

1101. *See id.* §§ 743(b), 734(b).

the combination of the adjustments under sections 734(b) and 743(b), Parcels 2 and 3, effectively, have an adjusted basis to B and C of $2.5 million each determined as follows:

(a) Parcels 2 and 3 each had $1.5 million basis after the section 734(b) inside basis adjustments (described above) upon the distribution of Parcel 1 to A.[1102]

(b) A's death gives rise to a $2 million adjustment under section 734(b) to the estate's share of inside basis in Parcels 2 and 3, which remain held by ABC Family, LLC.[1103]

(c) Under section 755, the taxpayer must allocate the $2 million positive adjustment across Parcels 2 and 3 to increase the estate's share of inside basis attributable to Parcels 2 and 3.[1104]

(d) The Treasury regulations under section 755 allocate the $2 million adjustment in proportion to relative fair market values of assets inside ABC Family, LLC.[1105]

(e) Because Parcels 2 and 3 have the same value, $5 million each, the estate's $2 million adjustment under section 743(b) is allocated equally between Parcels 2 and 3.[1106]

(f) Therefore, the estate's share of the inside basis of ABC Family, LLC in Parcels 2 and 3 is $1 million each.[1107]

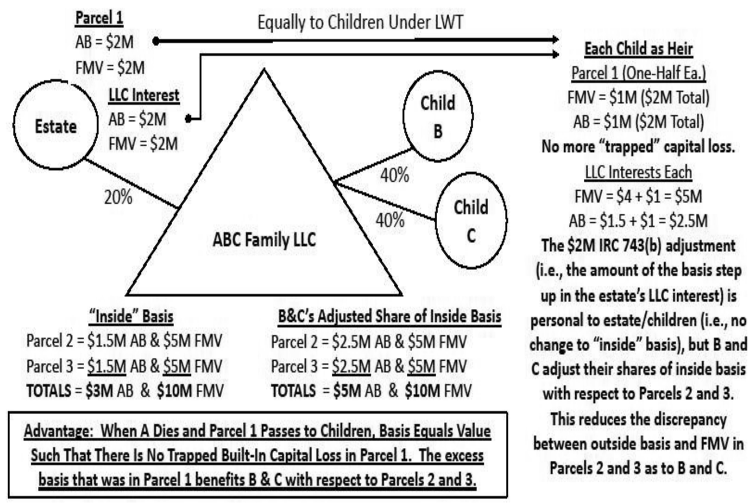
(g) B and C then inherit the estate's share of ABC Family, LLC's $1 million inside basis in Parcels 2 and 3.[1108]

(h) When combined with ABC Family, LLC's existing inside basis of $1.5 million each in Parcels 2 and 3, B's and C's inside shares of basis in Parcels 2 and 3 are now $2.5 million each.[1109]

A diagram illustrating the ultimate results to A's estate, B, and C is set forth below:

1102. *See id.* §§ 734, 743.
1103. *See id.* §§ 734, 743.
1104. *See id.* § 755.
1105. *See id.*
1106. *See id.* § 743(b).
1107. *See id.* §§ 731–33.
1108. *See id.* §§ 731–33.
1109. *See id.* §§ 731–33.

ABC Family LLC Alternative Two: Step-Up at Death in Parcel 1 and LLC Interest



As can be seen from the foregoing analysis and the diagram, the carefully planned distribution of Parcel 1 optimizes the results of the section 754 election.[1110] In other words, the basis and value of Parcel 1 in B's and C's hands is equal, therefore avoiding receipt of property with built-in loss that can be realized only upon sale.[1111] Further, B's and C's inside shares of basis in Parcels 2 and 3 within ABC Family, LLC are higher—$2.5 million each versus $1.835 million each—than when Parcel 1 is not distributed and A dies holding a 33.34% interest in ABC Family, LLC.[1112]

In short, the carefully planned distribution of Parcel 1 reallocated $2 million of excess basis to Parcels 2 and 3 to reduce their built-in gain, rather than trapping a large portion of that excess basis as built-in loss in Parcel 1.[1113]

VI. INCOME TAX AVOIDANCE AND DEFERRAL

A. Generally

With the higher income tax rates, progressivity in the marginal income tax brackets provides an opportunity for taxpayers to take advantage of "running the brackets" and taxing income at lower effective tax rates.[1114] With the

1110. *See id.* § 754.
1111. *See id.*
1112. *See id.*
1113. *See id.*
1114. *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

highest income tax rates becoming effective at $457,600 of taxable income for joint filers and the 3.8% Medicare tax being applied when MAGI exceeds $250,000, the tax savings can be quite significant.[1115] At ordinary rates, running the bracket provides approximately $42,954 of tax savings (the difference between being taxed at the highest rate of 43.4% and the actual tax liability) for single filers and $53,247 for joint filers, and at long-term capital gain tax rates, the tax savings are $29,783 and $36,070, respectively:[1116]

STCG/Ordinary Rate	**Single ($42,954 in savings)**	**Joint ($53,247 in savings)**
10%	$0-$9,075	$0-$18,150
15%	$9,076-$36,900	$18,151-$73,800
25%	$36,901-$89,350	$73,801-$148,850
28% / 31.8%	$89,351-$186,350	$148,851-$226,850
33% / 36.8%	$186,351-$405,100	$223,851-$405,100
35% / 38.8%	$405,101-$406,750	$405,101-$457,600
39.6% / 43.4%	$406,751+	$457,601+

LTCG/QD Rate	**Single ($29,783 in savings)**	**Joint ($36,070 in savings)**
0%	$0-36,900	$0-$73,800
15%	$36,901-*$200,000 MAGI*	$73,801-*$250,000 MAGI*
18.8%	*$200,001 MAGI*-$406,750	*$250,001 MAGI*-$457,600
23.8%	$406,751+	$457,601+

1115. *See id.*
1116. *Id.*

As a result, taxpayers will increasingly look for opportunities to not only defer the payment of income taxes, which provides a present value economic benefit, but also have the income spread out over many taxable years and over multiple taxpayers. This will provide the benefit of having the income taxed at a lower tax rate by running the brackets, and to also fully avoid the imposition of certain taxes like the 3.8% Medicare tax, for such annual amounts that remain below $200,000 to $250,000 of MAGI.[1117]

B. "Splitting" Income with Partnerships

The most flexible vehicle available to practitioners to "split" income among taxpayers is entities taxed as partnerships.[1118] While an S corporation will spread the entity's income across the shareholders, the capital structure of an S corporation investment is limited to one class of stock; therefore, there is no ability to disproportionately allocate income to certain shareholders, who are taxed at lower marginal income tax brackets and who may not be subject to state income tax, to the exclusion of other shareholders, who are already at the highest income tax brackets and who may be residents of a high income tax state like California.[1119]

Unlike S corporations, partners can structure partnerships to provide different classes of ownership interests.[1120] In the family-owned entity context, if different ownership interests are utilized, careful consideration must be given to section 2701 because the "same class"[1121] exception will not be available.[1122] Notwithstanding the foregoing, "preferred" partners can create preferred partnership interests that avoid the punitive effects of section 2701, namely the "zero valuation" rule.[1123] These types of preferred interests include:

(a) A "qualified payment" interest, discussed in more detail later in the article, which is an exception to the zero valuation rule; [1124]

(b) A "deemed" or "electing" qualified payment, which is an exception to the zero valuation rule;[1125]

(c) A "guaranteed payment" right under section 707(c), which is an exception to section 701;[1126] and

1117. *See id.*
1118. *See* I.R.C. § 1361(b)(1)(D) (2012).
1119. *See id.*
1120. *See id.*
1121. *See id.* § 2701(a)(2)(B).
1122. *See id.*
1123. *See id.* § 2701(a)(3)(A).
1124. *See id.*
1125. *See id.* § 2701(c)(3)(C)(ii). These are specified amounts to be paid at specified times that nonetheless do not qualify as a "qualified payment" but that the taxpayer elects to treat as such. *See id.*
1126. *See id.* § 707(c). Excluded from the definition of "distribution right" is "any right to receive any guaranteed payment described in Section 707(c) of a fixed amount." *See id.* The Code defines guaranteed payments as "payments to a partner . . . for the use of capital" but only "to the extent determined without regard to the income of the partnership to a partner for . . . the use of capital." *See id.* The Treasury

(d) A "mandatory payment right," which is an exception to section 2701.[1127]

Generally, the Code and the IRS take the position that if a partner holds a preferred interest in a partnership, taxable income should follow with the preferred interest payment.[1128]

For guaranteed payment rights, the taxation to the partnership and the partners is relatively straightforward. A partnership that makes a guaranteed payment to a partner is entitled to either deduct the payment as an ordinary and necessary business expense of the partnership or capitalize the expense as a capital expenditure, depending on the nature of the payment.[1129] The partner receiving the guaranteed payment must include the payment as ordinary income in the year in which the partnership paid or accrued the payment under its method of accounting.[1130]

For the other types of preferred interests, the allocation of income is a bit more convoluted. Generally, the income allocated to the preferred payment depends on the distributive share of the partnership. The McKee, Nelson, and Whitmire treatise provides that the Service expects a preferred return to be matched by a corresponding allocation of available income or gain.[1131] The Treasury regulations, in the context of the disguised sale rules, provide that "a preferred return means a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain."[1132]

With the goal of disproportionately allocating income to lower taxed individuals, practitioners should make note of the "junior equity" exception to section 2701.[1133] The Code provides that a "distribution right does not include a right to distributions with respect to any interest which is junior to

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regulations go on to explain that a guaranteed payment is meant to provide the partner with a return on the partner's investment of capital (as opposed to payments designed to liquidate the partner's interest in the partnership). Treas. Reg. § 1.707-4(a)(1)(i) (1992).

1127. *See* I.R.C. § 2701; Treas. Reg. § 25.2701-2 (1992). A "mandatory payment right" is a right to a required payment at a specified time. *See* Treas. Reg. § 25.2701-2. For purposes of section 2701, a mandatory payment right is considered neither an extraordinary payment right nor a distribution right. *See* I.R.C. § 2701. A mandatory payment right includes a right in preferred stock requiring that the stock be redeemed at its par value on a date certain and also includes a right to receive a specific amount on the death of the holder. Treas. Reg. § 25.2701-2(b)(4)(i). The Service has also ruled that a mandatory payment right includes the right to redeem preferred stock at a stated value plus any accrued and unpaid dividends on the earlier to occur of a certain date or change in control of the company. *See* Treas. Reg. § 25.2701-2(b)(4)(i); I.R.S. Priv. Ltr. Rul. 98-48-006 (Nov. 27, 1998).

1128. *See* Treas. Reg. § 25.2701-4 (1992).

1129. *See* I.R.C. §§ 162(a), 263, 707(c) (2012).

1130. *See id.* §§ 61(a), 706(a); Treas. Reg. §§ 1.706-1(a)(1) (as amended in 2012), 1.707-1(c) (as amended in 1983).

1131. WILLIAMS MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 14.02(3)(b)(iii) at 3–19 (3d ed. 1997).

1132. Treas. Reg. § 1.707-4(a)(2) (1992).

1133. *See* I.R.C. § 2701(c)(1)(B)(i).

the rights of the transferred interest."[1134] The Treasury regulations also exempt "an interest that is of the same class, or a class that is subordinate to, the transferred interest."[1135]

This is one of the most significant exceptions to section 2701 from a tax planning standpoint.[1136] Essentially, the exception is for the transferor to transfer the preferred or senior equity interest and retain the junior equity or common interest.[1137] As an exception to section 2701, normal gift tax rules apply to such transfer of the preferred interest, along with any applicable valuation discounts for lack of marketability and minority interest discount.[1138] Equally as important, as mentioned above, the preferred return will carry a preferred allocation of the tax items of the partnership.[1139]

C. Non-Grantor Trusts: Distributions and Partnerships

As mentioned above, non-grantor trusts are taxed at the highest rates once taxable income exceeds $12,150.[1140] As such, non-grantor trusts carry an inherent income tax disadvantage when compared to how those same assets would grow if they were held by an individual or group of individual taxpayers.[1141] The trustee should consider whether making distributions to trust income might better serve the overall purposes of the grantor and the grantor's family, in terms of total wealth accumulation.[1142]

Even when the trust's primary objective is to accumulate as much wealth in the trust as possible (for example, a "dynasty trust" or GST tax exempt trust), the trustee may be able to produce more total wealth by distributing trust income out to the trust beneficiaries—especially if the trust beneficiaries would be taxed at lower income tax rates, would not be subject to state income tax, and would have sufficient Applicable Exemption Amount and GST exemption available to shelter whatever assets may accumulate in the gross estates of the beneficiaries.[1143] Given the potential number of taxpayers or beneficiaries a trust could spread the income across, the savings could be significant.[1144]

Trust distributions that carry out distributable net income (DNI) of the trust would effectively ensure taxation of the income to the beneficiaries.[1145] DNI determines the amount of income that may be deducted by the trust resulting from distributions and determines the character of the income items

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1134. *Id.*
1135. Treas. Reg. § 25.2701-2(b)(3)(i) (1992).
1136. *Id.*
1137. *See* I.R.C. § 2701(a)(2).
1138. *See id.* § 2511(a).
1139. *See id.* § 2701.
1140. *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 537.
1141. *See id.*
1142. *See id.*
1143. *See* I.R.C. §§ 641, 651, 652 (2012).
1144. *See id.* §§ 641, 651, 652.
1145. *See id.* § 643.

taxable to the beneficiaries.[1146] Determining DNI for a trust requires, first, determining the taxable income of the trust and, second, modifying that figure in a number of ways.[1147] With respect to capital gain, the Code provides that "[g]ains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not . . . paid, credited or required to be distributed to any beneficiary during the taxable year."[1148] In other words, absent certain circumstances, capital gain is excluded from DNI and is taxable to the trust rather than to the beneficiary receiving the distributions.[1149]

Often the governing instrument will give the trustee the authority to allocate gains between income and principal.[1150] Under the Treasury regulations, however, "[t]rust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized."[1151] The Treasury regulations provide that capital gain is ordinarily excluded from DNI; however, there are notable exceptions, which can be explained as:[1152]

> Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law):
>
> > (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of the distributable net income determined without regard to this subparagraph 1.643(a)-3(b));
> >
> > (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

1146. *See id.* §§ 651(b), 652(a)–(b), 661(a), 662(a)–(b).
1147. *See id.* §§ 651(b), 652(a)–(b), 661(a), 662(a)–(b).
1148. *See id.* § 643(a)(3); *see also* Treas. Reg. § 1.643(a)-3(a) (as amended in 2004) (regarding the treatment of capital gains and losses in the taxable year in which the trust or estate terminates).
1149. *See* I.R.C. § 643(a); *see also* Treas. Reg. § 1.643(a)-3(a).
1150. *See* Treas. Reg. § 1.643(a)-3(b).
1151. *Id.* § 1.643(b)-1.
1152. *Id.* § 1.643(a)-3(a).

> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.[1153]

Notwithstanding the limited discretion granted to fiduciaries under the foregoing provisions, given the potential limitations of including capital gain in DNI and the fact that many clients would prefer not to have the asset held personally by the beneficiaries, practitioners may be able to accomplish the same types of tax savings by utilizing a partnership structure where the beneficiary is a partner along with the trust.[1154] By way of example, the trust could form an entity taxable as a partnership, like a limited partnership or limited liability company, and distribute an interest in the entity to the beneficiary.[1155] Whether such distribution carries out DNI to the beneficiary is secondary to the fact that on an ongoing basis a proportionate amount of partnership income will be allocated to the beneficiary.[1156] While a preferred interest partnership structure can be utilized, as discussed above, practitioners should be aware of the implications under section 2701 upon the creation of the preferred partnership with the beneficiary or the distribution of a preferred interest in the partnership to the beneficiary.[1157]

Given that any partnership interest held by a trust beneficiary will be in their gross estate for estate tax purposes, practitioners will want to consider utilizing IDGTs to minimize the estate tax impact but still retain the income tax benefits of having the partnership income taxed to the beneficiary-grantor.[1158] For example, the beneficiary may want to sell their partnership interest to an IDGT created by the beneficiary, as the grantor, for grantor trust purposes.[1159]

D. Charitable Remainder Trusts

The tax benefits of CRTs have dramatically increased with the progressivity of the new income tax rates, especially if a taxpayer is considering a relatively large taxable sale of a highly appreciated investment asset like publicly traded corporate stock.[1160] For example, if a taxpayer sells $5 million of zero basis stock, the effective federal tax rate of that sale is 22.9%, assuming a long-term holding period, and if a taxpayer sells $10

1153. *Id.* § 1.643(a)-3(b). Since the issuance of the final regulations, the Service has ruled that the exclusion and inclusion of capital gains in determining DNI was a reasonable exercise of discretion. *See* I.R.S. Priv. Ltr. Rul. 2006-17-004 (Apr. 28, 2006); I.R.S. Priv. Ltr. Rul. 2004-44-8001 (Nov. 26, 2004).

1154. *See* Treas. Reg. § 1.704-1 (as amended in 2013).

1155. *See id.*

1156. *See id.* § 1.704-1(b)(1)(i).

1157. *See* I.R.C. § 2701 (2012).

1158. 10 ERIC D. SPOTH, MERTENS LAW OF FEDERAL INCOME TAXATION § 37:3 (2014).

1159. *See id.*

1160. *See Tax Incentives for a Charitable Remainder Trust*, FIND LAW, http://estate.findlaw.com/trusts/tax-incentives-for-a-charitable-remainder-trust.html (last visited Oct. 26, 2014).

million of stock, the effective federal tax rate is 23.4%.[1161] In other words, large sales like this in a single taxable year effectively result in virtually all of the gain being taxed at the highest tax bracket (23.8%) because the income thresholds at the highest tax bracket ($406,750/$457,600 and $200,000/ $250,000 for the Medicare tax) are so small in comparison to the total taxable income.[1162]

Now, contrast how the sale of such stock would be taxed if the stock is first contributed to a CRT, most likely as a charitable remainder unitrust given how low the section 7520 rate is today.[1163] A CRT is not subject to income tax, so the trustee's subsequent sale of the appreciated stock will not result in an immediate tax liability to the trust or to the unitrust recipient.[1164]

The "tier rules," under section 664(b) and the Treasury regulations, determine the taxability of the unitrust payment to the recipient.[1165] The tier rules create a historical accounting of how the charitable remainder trust has realized (but not recognized) income in the administration and investment of the trust assets.[1166] Effectively, the tier rules tax each distribution on a "worst-in, first-out" basis with distributions deemed to consist first of ordinary income, then from capital gain, followed by "other" income like tax-exempt bond income, and finally from trust corpus.[1167] The final Treasury regulations make clear that if there are different classes of income in a category, the class of income that would be subject to the highest federal income tax rate will be deemed to be distributed before a class of income that would be taxed at a lower rate.[1168] Hence, ordinary income from taxable bonds will be deemed distributed before qualified dividends, and short-term capital gains will be deemed distributed before long-term capital gains.[1169] These are often referred to as the "category and class" tier rules.[1170]

Notwithstanding the worst-in, first-out nature of the annual distributions, if trustees are careful in the investment of the assets, much of each distribution will be taxed at qualified dividend and long-term capital gain rates.[1171] Given the large amount of capital gain that is recorded under the tier rules, when a highly-appreciated asset is initially sold, as annual payments are made to the

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1161. *See* David J. Marotta, *Capital Gains Tax Gets More Complicated*, FORBES (May 25, 2014), http://www.forbes.com/sites/davidmarotta/2014/05/25/capital-gains-tax-gets-more-complicated/.

1162. *See id.*

1163. This is due to the interplay of the 5% minimum amount for annuity amounts, the 5% exhaustion test, and the 10% minimum charitable remainder interest requirement. *See* Treas. Reg. §§ 1.664-2(a)(2)(i) (as amended in 2011), 25.2522(c)-3(b)(1) (as amended in 2011); I.R.C. § 664(d)(1)(D) (2012).

1164. I.R.C. § 664(c)(1).

1165. Treas. Reg. § 1.664-1(d).

1166. *Id.* § 1.664-4(a)(1)(i).

1167. *Id.* § 1.664-1(d)(1)(ii)(1)–(4).

1168. *Id.* § 1.661-1(D)(1)(ii)(b).

1169. *Id.*

1170. *See* Paul Lee & Stephen Schilling, *CRTs Are Back (In Four Delicious Flavors)*, WEALTH MGMT. (Sept. 24, 2014), http://wealthmanagement.com/philanthropy/crts-are-back-four-delicious-flavors.

1171. Treas. Reg. § 1.664-1(d)(1)(iv).

recipient, the original capital gain is essentially being paid out over time.[1172] This effectively results in not only a deferral of the original capital gain tax liability but, to the extent that each annual payment is below the highest income tax threshold, it causes the gain to be taxed at a lower effective rate.[1173] For example, assuming the unitrust recipient had no other sources of income, the first $200,000 or $250,000—depending on whether the recipient filed jointly or as a single filer—would fully avoid the 3.8% Medicare tax, and the first $406,750 or $457,600 would be taxed at a rate lower than the highest marginal income tax bracket.[1174]

The income tax savings become even more compelling if the fully taxable sale would have occurred when the taxpayer was a resident of a high income tax state like California, where the highest bracket of 13.3% is imposed on taxable income over $1 million.[1175] A sale of the appreciated stock in a CRT would not only provide deferral benefits if the unitrust recipient continued to be a resident of California, but the unitrust recipient could fully avoid the state income tax if the recipient moved to a state with no income tax like Texas, Florida, or Nevada.[1176]

E. NINGs/DINGs

Taxpayers in high income tax states, like California, often look for opportunities to defer or avoid their state income tax exposure.[1177] In light of this objective, the use of "incomplete gift, non-grantor trusts" has arisen in states that do not have an income tax.[1178] Most prevalently, practitioners have taken advantage of the laws of Delaware (Delaware incomplete non-grantor trust or DING) and Nevada (Nevada incomplete non-grantor trust or NING).[1179] Pursuant to this technique, as long as the assets are retained in the DING or NING, the income from such assets will not be subject to state income tax.[1180]

1172. *See* Michael Kites, *What's the Real Value of Deferring Capital Gains? Less Than Most People Think. . .*, NERD'S EYE VIEW (Dec. 26, 2012), http://www.kitces.com/blog/whats-the-real-value-of-deferring-capital-gains-less-than-most-people-think/.

1173. *See id.*

1174. *See id.*

1175. *See California: The Facts on California Tax Climate*, TAX FOUND., http://taxfoundation.org/state-tax-climate/california (last visited Oct. 26, 2014).

1176. *See* Dan Dzombak, *The 7 States With No Income Tax*, MOTLEY FOOL (Apr. 5, 2013), www.fool.com/investing/general/2013/04/05/The-7-states-with-no-income-tax.aspx.

1177. *See* Peter Melcher & Steven Ashins, *New Private Letter Ruling Breathes Life Into Nevada Incomplete Gift Non-Guarantor Trusts*, WEALTH MGMT. (Apr. 16, 2013), http://wealthmanagement.com/estate-planning/new-private-letter-ruling-breathes-life-nevada-incomplete-gift-non-grantor-trusts.

1178. *See id.*

1179. *See id.* (providing a more complete discussion of NINGs and DINGs); *see also* Steven J. Oshins, *NING Trusts Provide Tax and Asset Protection Benefits*, EST. PLAN. REV. J. 150 (Aug. 20, 2013), http://www.oshins.com/images/NING_Trusts_-_CCH.pdf (providing a more complete discussion of NINGs and DINGs).

1180. S*ee* Melcher & Ashins, *supra* note 1177.

The salient features of DING and NING planning are:

1. The taxpayer creates a non-grantor trust;

2. The taxpayer contributes assets to the trust that the taxpayer no longer wants to be subject to state income tax;

3. The trust provides that the taxpayer/grantor is a permissible beneficiary of the trust;

4. The contribution of assets to the non-grantor trust are not considered a taxable gift; and

5. The assets in the non-grantor trust will be includible in the taxpayer/grantor's estate for estate tax purposes.[1181]

Prior to 1997, a self-settled trust (a trust that provides for the benefit of the grantor), like the one described above, would not have qualified as a non-grantor trust.[1182] The Treasury regulations provide that "[u]nder section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor."[1183] Thus, if under state law, creditors of the grantor can reach the assets of the trust, then the trust will be considered a grantor trust for income tax purposes.[1184] Prior to 1997, all of the states provided that creditors of a grantor could reach the assets of any self-settled trust.[1185] Since 1997, a number of states, such as Alaska, Delaware, and Nevada, have enacted "domestic asset protection trusts" (DAPTs) that purportedly allow grantors to create self-settled trusts but prohibit creditors of the grantor from reaching the assets in the trust.[1186]

A number of rulings under Delaware law affirmed the non-grantor trust status of the DING.[1187] All of the rulings relied upon an incomplete gift predicated upon the grantor retaining a special testamentary power of appointment to redirect the trust assets.[1188] Notwithstanding that the grantor was a permissible beneficiary of the trust, the rulings avoided grantor trust status through the use of a distribution committee that had to approve any distribution to the grantor.[1189] The members of the distribution committee

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1181. *See id.*

1182. *See* Richard W. Nenno & Jeffrey C. Wolken, *A Practitioners Friendly Guide to the Delaware Asset Protection Trust*, WILMINGTON TR., http://www.wilmingtontrust.com/repositories/wtc_sitecontent/PDF/practitioner-guide.pdf (last visited Nov. 6, 2014).

1183. Treas. Reg. § 1.677(a)-(1)(d) (as amended in 1996).

1184. *See* Oshins, *supra* note 1177.

1185. *Id.*

1186. *Id.*

1187. I.R.S. Priv. Ltr. Rul. 2001-48-0128 (Nov. 20, 2001); I.R.S. Priv. Ltr. Rul. 2002-47-013 (Nov. 22, 2002); I.R.S. Priv. Ltr. Rul. 2005-02-014 (Jan. 14, 2005); I.R.S. Priv. Ltr. Rul. 2006-12-002 (Mar. 24, 2006); I.R.S. Priv. Ltr. Rul. 2006-37-025 (Sept. 15, 2006); I.R.S. Priv. Ltr. Rul. 2006-47-001 (Nov. 24, 2006); I.R.S. Priv. Ltr. Rul. 2007-15-005 (Apr. 13, 2007); I.R.S. Priv. Ltr. Rul. 2007-31-019 (Aug. 3, 2007).

1188. *See* Treas. Reg. § 25.2511-2(b), (c) (as amended in 1999).

1189. *See* I.R.S. Priv. Ltr. Rul. 2001-48-0128 (Nov. 20, 2001); I.R.S. Priv. Ltr. Rul. 2002-47-013 (Nov. 22, 2002); I.R.S. Priv. Ltr. Rul. 2005-02-014 (Jan. 14, 2005); I.R.S. Priv. Ltr. Rul. 2006-12-002 (Mar. 24, 2006); I.R.S. Priv. Ltr. Rul. 2006-37-025 (Sept. 15, 2006); I.R.S. Priv. Ltr. Rul. 2006-47-001 (Nov. 24, 2006); I.R.S. Priv. Ltr. Rul. 2007-15-005 (Apr. 13, 2007); I.R.S. Priv. Ltr. Rul. 2007-31-019 (Aug. 3, 2007).

were deemed to be adverse parties (for example, trust beneficiaries) under section 672(a), and as a result, the trust was not a grantor trust.[1190]

In 2007, the IRS announced that it was re-examining the question of whether the distribution committee members have a general power of appointment.[1191] In 2012, the IRS ruled that the retention of a testamentary power of appointment makes the original transfer incomplete, but only with respect to the remainder interest, not the lead interest.[1192]

More recent rulings under Nevada law have confirmed the NING technique.[1193] The taxpayers in the rulings addressed the power of appointment issue by providing the trust settlor with an *inter vivos* special power of appointment for health, education, maintenance, and support in a nonfiduciary capacity.[1194] Further, the powers of the distribution committee members were only exercisable in conjunction with the grantor.[1195] Thus, the IRS ruled that the members did not have general powers of appointment.[1196]

VII. Creative Uses of the Applicable Exclusion

A. Qualified "Cost-of-Living" Preferred Interests

As mentioned above, there are very good reasons for trying to retain as much Applicable Exclusion Amount as possible, even for very wealthy clients who have significant estate tax exposure. One technique that may be appealing is a traditional preferred freeze partnership, in which the grantor retains a preferred interest in the partnership and gifts or, more likely, sells to an IDGT, a common interest in the partnership.[1197] The twist would be that the retained preferred interest would be adjusted for inflation to provide inflation-adjusted cash flow and ensure that the retained preferred interest in

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1190. *See* I.R.S. Priv. Ltr. Rul. 2001-48-0128 (Nov. 20, 2001); I.R.S. Priv. Ltr. Rul. 2002-47-013 (Nov. 22, 2002); I.R.S. Priv. Ltr. Rul. 2005-02-014 (Jan. 14, 2005); I.R.S. Priv. Ltr. Rul. 2006-12-002 (Mar. 24, 2006); I.R.S. Priv. Ltr. Rul. 2006-37-025 (Sep. 15, 2006); I.R.S. Priv. Ltr. Rul. 2006-47-001 (Nov. 24, 2006); I.R.S. Priv. Ltr. Rul. 2007-15-005 (Apr. 13, 2007); I.R.S. Priv. Ltr. Rul. 2007-31-019 (Aug. 3, 2007).

1191. I.R.S. News Release IR-2007-127 (July 9, 2007).

1192. I.R.S. Chief Counsel Advisory 2012-08-026 (Feb. 24, 2012).

1193. I.R.S. Priv. Ltr. Rul. 2013-10-002 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-003 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-004 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-005 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-006 (Mar. 8, 2013).

1194. *See* I.R.S. Priv. Ltr. Rul. 2013-10-002 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-003 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-004 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-005 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-006 (Mar. 8, 2013).

1195. *See* I.R.S. Priv. Ltr. Rul. 2013-10-002 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-003 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-004 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-005 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-006 (Mar. 8, 2013).

1196. *See* I.R.S. Priv. Ltr. Rul. 2013-10-002 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-003 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-004 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-005 (Mar. 8, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-006 (Mar. 8, 2013).

1197. *See* Dean Mead et al., *Estate Planning After the American Taxpayer Relief Act of 2012*, DEAN MEAD 22 (Mar. 19, 2013), http://www.deanmead.com/wp-content/uploads/2011/03/Estate-Planning-Outline.-American-Taxpayer-Relief-Act-O0832058.pdf.

the gross estate would equal the grantor's Applicable Exclusion Amount on the grantor's death.[1198] Pursuant to this technique:

a. The retained preferred interest would be structured as a "qualified payment" interest under section 2701, so the zero valuation rule would not be applicable.[1199]

b. The liquidation preference of the preferred interest would be adjusted to provide for a cost-of-living increase, calculated in the same manner as the Applicable Exclusion Amount.[1200]

c. The retained preferred interest would be structured so that the preferred holder would have the right to put the interest to the partnership for the liquidation preference (as adjusted for the cost-of-living increase), and at death, the partnership has the right to liquidate the preferred interest at the liquidation preference.[1201]

d. The gift or sale of the common interest would qualify for significant valuation discounts, in excess of those that would typically apply to a traditional single class or pro rata family limited partnership.[1202]

A qualified payment "means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate."[1203] A payment will be treated as a "fixed rate" if the payment is "determined at a rate which bears a fixed relationship to a specified market interest rate."[1204] The Treasury regulations provide that a qualified payment is:

> (A) A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate;[1205]
>
> (B) Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount . . . .[1206]

A common inflation-sensitive interest rate investment is a Treasury Inflation-Protected Security (TIPS).[1207] TIPS, unlike certain U.S. savings bonds, adjust for inflation by providing inflation adjustments to the underlying

1198. *See id*.
1199. I.R.C. § 2701(a)(3)(A) (2012).
1200. *See* Mead, *supra* note 1197, at 2.
1201. *See id*.
1202. *See id*.
1203. I.R.C. § 2701(c)(3)(A).
1204. *Id.* § 2701(c)(3)(B); *see* Treas. Reg. § 25.2701-2(b)(6)(ii) (1992).
1205. Treas. Reg. § 25.2701-2(b)(6)(i)(A).
1206. *Id.* § 25.2701-2(b)(6)(i)(B).
1207. *See id*. § 1.1275-7.

principal amount and keeping the yield fixed.[1208] For example, if a $100,000 TIPS is issued with a 4% yield, then $4,000 of interest will be paid in the first year.[1209] Assume inflation is 3% in the ensuing year. The TIPS adjusted principal amount will be $103,000 but the yield remains at 4%.[1210] As a result, the ensuing year's interest payment will be $4,120.[1211] TIPS are an example of a larger category of investments under the Code, called an inflation-indexed debt instrument (IIDI).[1212] The Treasury regulations define an IIDI as a debt instrument that has the following features:

(a) It is issued for U.S. dollars and all payments are denominated in the same;[1213]

(b) Except for a minimum guarantee, each payment is indexed for inflation or deflation;[1214] and

(c) No payments are subject to any contingencies other than inflation or deflation.[1215]

1. Terms of the Qualified "Cost-of-Living" Preferred Interests

The partnership will provide a cumulative preferential right to partnership cash flow.[1216] Typically, this preferential right will be a percentage of a stated liquidation preference amount (for example, 6% of $5.34 million—the current Available Exclusion Amount).[1217] In this instance, the taxpayer should structure the liquidation preference similarly to take into account future inflation or deflation as the IRS adjusts the TIPS.[1218]

The preferred payment will accrue annually and will be cumulative to the extent the partnership makes no payments in any given year.[1219] The payment accrues and is payable regardless of partnership profits.[1220] As such, while the partnership normally makes payments from net cash flow of the partnership, the lack of net cash flow in any given year will not affect the total

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1208. *See id.*

1209. *See id.*

1210. *See id.*

1211. *See id.*

1212. *See id.*

1213. *Id.* § 1.1275-7(c)(1).

1214. *Id.* § 1.1275-7(c)(1)(ii). The taxpayer makes an additional payment "at maturity if the total inflation-adjusted principal paid on the [IIDI] is less than the [IIDI's] stated principal amount." *Id.*

1215. *Id.* § 1.1275-7(c)(1)(iii). "A qualified inflation index is [any] general price or wage index that is updated and published at least monthly by an agency of the [U.S.] Government." *Id.* § 1.1275-7(c)(3). The Treasury regulations specifically mentioned "the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U)." *Id.*

1216. N. Todd Angkatavanich & Edward A. Vergara, *Preferred Partnership Freezes*, WEALTH MGMT. (May 1, 2011), http://wealthmanagement.com/estate-planning/preferred-partnership-freezes-0.

1217. *Id.*; *see also Estate Tax*, IRS, http://www.irs.gov/Business/small-business-+-self-employed/estate-tax (last updated Sept. 29, 2014).

1218. *See* Angkatavanich & Vergara, *supra* note 1216.

1219. *Id*.

1220. *See id*.

amount due.[1221] The preferred payment will go into arrears for up to four years after the due date without interest due on the unpaid preference.[1222] After the four year period, the unpaid payments will accrue interest at the specified preferred rate (for example, 6%).[1223]

The partnership agreement will provide that the partnership may make payments from available cash and then at the discretion of the general partner, with in-kind distributions of partnership property. Upon dissolution, the preferred interest will receive liquidating distributions equal to the liquidation preference amount, $5.34 million as adjusted for inflation, before any distributions are made to non-preferred interest holders.[1224] Additionally, the partnership agreement will provide the partnership with the right to call the preferred interest at the liquidation preference amount upon the death of the preferred holder; this effectively freezes the value for transfer tax purposes at the liquidation preference amount and at the taxpayer's Applicable Exclusion Amount.[1225]

2. Chapter 14 Implications

The regular gift tax rules determine the valuation of the preferred interest in the Subtraction Method under section 2701 because it is a "qualified payment."[1226] It is unclear, however, what standard should be used in valuing the preferred interest.[1227] Stated another way, how does one determine the appropriate preferred annual payment to minimize the gift tax consequences, if any, under section 2701?[1228]

The preferred interest must generally provide for a cumulative and annual payment determined at a fixed rate to be a qualified payment.[1229] While the taxpayer must ignore certain "bells and whistles," no other requirements are in the Code or the Treasury regulations.[1230]

3. Revenue Ruling 83-120

Many commentators and the IRS, through rulings, have asserted that the appropriate standard for valuing the preferred interest is under Revenue

1221. *See id*.
1222. Treas. Reg. § 25.2702-4(c)(ii)(5) (1992).
1223. *See id.*
1224. *See* Angatavanich & Vergara, *supra* note 1216.
1225. *See id*.
1226. Treas. Reg. § 25.2701-1(a) (as amended in 1994).
1227. *See id.* § 25.2701-1.
1228. *See id.*
1229. *See* discussion *supra* Part VII.A.1.
1230. I.R.C. § 2701 (2012); Treas. Reg. § 25.2701-1.

Ruling 83-120, pertaining to preferred corporate stock.[1231] The Revenue Ruling provides a methodology for valuing preferred interests, based upon three primary factors: yield, preferred payment coverage, and protection of the liquidation preference.[1232]

The taxpayer compares the yield of the preferred interest with the dividend yield of "high-grade, publicly traded preferred stock."[1233] The required credit rating is not explicitly stated in the ruling.[1234] The ruling does point out, however, that "[i]f the rate of interest charged by independent creditors to the [entity] on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred [interest] should be correspondingly higher than the yield on the high quality preferred stock."[1235]

The ruling provides that "[c]overage of the dividend is measured by the ratio of the sum of the pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends."[1236] Obviously, in the partnership context, due to pass-thru taxation under Subchapter K, concerns about pre-tax earnings and after-tax dividends are not relevant.[1237] If the partnership agreement provides that the entity can satisfy the preferred payment from both cash flow of the partnership and distributions in-kind of partnership assets, it supports further coverage.[1238]

Comparing the value of the partnerships assets (net of liabilities) to the liquidation preference amount determines the protection of the liquidation preference.[1239] In other words, what is the ratio of preferred interests in comparison to non-preferred interests?[1240]

From a planning perspective, dividend (preferred payment) coverage and liquidation protection are within the control of the planner, whereas the yield on publicly-traded preferred stocks is determined by the vagaries of the market at the time of the purported transfer.[1241] In other words, if a taxpayer recapitalizes an FLP into a qualified payment preferred FLP, then the amount of dividend coverage or liquidation protection is a function of the sizing between the preferred and common interests.[1242] For example, dividend

1231. Aaron M. Stumpf & Brian A. Hock, *Freeze Partnership's Establishing the Preferred Rate*, STOUT RISIUS ROSS, http://www.srr.com/article/freeze-partnerships-establishing-preferred-rate (last visited Oct. 26, 2014); I.R.S. Priv. Ltr. Rul. 93-24-018 (June 18, 1993); Rev. Rul. 83-120, 1983-2 C.B. 170.

1232. Rev. Rul. 83-120, 1983-2 C.B. 170. The ruling also indicates that voting rights and lack of marketability are secondary factors, but these may cancel each other out in many instances. *Id.*

1233. *Id.*

1234. *Id.*

1235. *Id.* at 2.

1236. *Id.*

1237. *See id.*

1238. *See id.*

1239. *See id.*

1240. *See id.*

1241. *See id.*

1242. *See id.*

coverage and liquidation protection would be quite different if the taxpayer structured an AB partnership, which holds $10,000,000 of assets as follows: (i) A holding a 7% preferred on a $5,000,000 liquidation preference amount and B holding the common shares, and (ii) A holding a 7% preferred on a $9,000,000 liquidation preference amount and B holding the common shares. In the first instance, the effective yield that the taxpayer must pay from the portfolio is 3.5% per year, and there is a 2:1 ratio of liquidation protection ($10,000,000 of assets to satisfy a $5,000,000 liquidation preference). In the second instance, the effective yield is 6.3%, and there is a 10:9 ratio of liquidation protection ($10,000,000 of assets to satisfy a $9,000,000 liquidation preference). In the latter instance, the value of the preferred interest would most likely be much less than the liquidation preference of $9,000,000 because the required yield from the partnership is considerably higher (less dividend coverage) and there is very little cushion of liquidation protection.

The yield on a qualified "cost-of-living" preferred interest will be less than the fixed yield on a liquidation preference—just as the yield on TIPS is less than the yield on bonds that are not inflation-adjusted.[1243] This difference is referred to as "breakeven inflation."[1244] Breakeven inflation is the difference between the nominal yield on a fixed rate investment and the "real yield" on an inflation-adjusted investment of similar maturity and credit quality.[1245]

Practitioners may want to consider including a provision in the partnership or membership agreement providing that upon liquidation of the preferred holder's interest at death (equal to the liquidation preference), the most appreciated assets at the time of death shall satisfy the liquidation distribution.[1246] Whether a section 754 election is in place or not, these assets should have no tax consequences and a full step-up in basis when received.[1247]

B. "Busted" Section 2701 Preferred Interests

A "busted" section 2701 preferred interest involves the creation of a preferred interest in a partnership or limited liability company that is not a "qualified payment" under section 2701(c)(3) and the gifting of the common interest in a manner that mandates the "zero valuation" rule under the "subtraction method."[1248] Typically, the preferred interest payment is non-cumulative.[1249]

1243. *See* discussion *supra* Part VII.A.1.

1244. Jens Christen & James Gillan, *TIPS Liquidity, Breakeven Inflation, and Inflation Expectations*, FED. RES. BANK S.F. (June 20, 2011), www.frbsf.argleconomic-research/publication/economic-letter/2011/june/tips-liquidity-breakeven-inflation-expectations/.

1245. *See id.*

1246. *See id.*

1247. *See* I.R.C. § 736(b) (2012).

1248. *See id.* § 2701(c)(3); Treas. Reg. § 25.2701-1(a) (as amended in 1994).

1249. *See* Treas. Reg. § 25.2701-1(e).

For example, taxpayer owns an LLC that holds $5 million in assets. Taxpayer recapitalizes the LLC into preferred and common interests. The preferred interests have a $5 million liquidation preference and an 8% non-cumulative preferred annual payment ($400,000). The preferred holder has the right to put the preferred interest to the LLC at any time for the liquidation preference. The LLC has the right to liquidate the preferred interest for $5 million at the death of the preferred holder. The taxpayer gifts the common interests to an IDGT.

The preferred interest is not a "qualified payment" under section 2701(c)(3).[1250] As such, the subtraction method described in the Treasury regulations will determine the value of the gifted common interest, with the preferred interest (family-held senior equity interest) being assigned a value of zero in step two of the subtraction method.[1251]

The value attributed (with the preferred interest having zero value) to transferred common interest may be entitled to valuation discounts.[1252] The Treasury regulations provide that if the value of the transferred interest would have been determined (but for section 2701) with a "minority or similar discount," the amount of the gift is reduced by the excess of a "pro rata portion of the fair market value of the family-held interests of the same class . . . over . . . the value of the transferred interest (without regard to section 2701)."[1253] The Service has ruled that "minority or similar discount" includes a "discount for lack of marketability" with respect to the transferred interest (when the preferred interest was valued at zero).[1254]

If, for the sake of simplicity, we assume in the above-mentioned example that the gift of the common interest is calculated to be exactly $5 million, why would a taxpayer consider making this gift? The answer lies in the calculation of the estate tax upon the taxpayer's death.[1255] The tentative federal estate tax (before credits) is essentially computed against the sum of the decedent's taxable estate, and the "amount of adjusted taxable gifts."[1256] The Treasury regulations provide that if an individual (referred to as the "initial transferor") makes a transfer subject to section 2701 "in determining the Federal estate tax with respect to an initial transferor, the executor of the initial transferor's estate may reduce the amount on which the decedent's

1250. *See* I.R.C. § 2701(c)(3).

1251. Treas. Reg. § 25.2701-3(a)(2)(ii), (b)(2). Senior equity interest is "an equity interest in the entity that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest." *Id.*

1252. *Id.* § 25.2701-3(b)(4).

1253. *Id.* § 25.2701-3(b). The Treasury regulations provide that the value is "determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701." *Id.* § 25.2701-3(b)(4)(ii)(A).

1254. I.R.S. Tech. Adv. Mem. 94-47-004 (Nov. 25, 1994).

1255. *See* I.R.C. § 2001(a) (2012).

1256. *Id.* § 2001(b)(1)(A)–(B).

tentative tax is computed under section 2001(b) by the amount of the reduction."[1257]

Assuming there has been no subsequent transfer of the retained preferred interest, the amount of the reduction is "[t]he amount by which the initial transferor's taxable gifts were increased as a result of the application of section 2701 to the initial transfer."[1258] In other words, in our simple example, the amount of the reduction is exactly $5 million, the increase of the gift of the common.[1259] However, because the non-cumulative preferred can be liquidated at $5 million, the amount includible is also $5 million.[1260] As such, these two amounts should cancel each other out.[1261]

The Treasury regulations provide the following example that makes it clear that the reduction in adjusted taxable gifts is frozen in value:

> P, an individual, holds 1,500 shares of $1,000 par value preferred stock of X corporation (bearing an annual noncumulative dividend of $100 per share that may be put to X at any time for par value) and 1,000 shares of voting common stock of X. There is no other outstanding common stock of X.[1262]
> . . . .
>
> P continues to hold the preferred stock until P's death. The chapter 11 value of the preferred stock at the date of P's death is the same as the fair market value of the preferred stock at the time of the initial transfer. In computing the Federal estate tax with respect to P's estate, P's executor is entitled to a reduction of $1,500,000 under paragraph (a)(3) of this section.[1263]

The benefit to the taxpayer is that for as long as the taxpayer holds the preferred interest, the taxpayer presumably can choose to receive the preferred payment or not.[1264] If no preferred payment is received, all of the appreciation effectively passes to the common interests.[1265] The preferred interest is frozen in value with a reduction for estate tax purposes that essentially "zeroes-out" the estate tax liability attributable to the preferred interest.[1266]

Practitioners may want to consider providing for a provision in the partnership or membership agreement that states that upon liquidation of the preferred holder's interest at death (equal to the liquidation preference), it

1257. Treas. Reg. § 25.2701-5(a)(3) (1994).
1258. *Id.* § 25.2701-5(b)(2).
1259. *See id.* § 25.2701-5(a)(2).
1260. *See id.*
1261. *See id.*
1262. *Id.* § 25.2701-5(d)(1)(i).
1263. *Id.* § 25.2701-5(d)(3), ex. 2.
1264. *See id.* § 25.2701-5(a).
1265. *See id.*
1266. *See id.* § 25.2701-5(b).

shall be satisfied, to the extent possible, with assets that are most appreciated at the time of death.[1267] Whether a section 754 election is in place or not, these assets should be received without any tax consequences and with a full step-up in basis.[1268]

C. Private Annuity Sales

1. Generally

A private annuity involves the transfer of property from the transferor in exchange for the transferee's promise to make annual fixed payments for the lifetime of the transferor, or transferors.[1269] The transferor may be an individual or a revocable living trust, and the transferee may be an individual or an entity such as a trust, a partnership, or a corporation.[1270] Typically, private annuity sales are to IDGTs (rather than non-grantor trusts) for the benefit of the transferor's descendants.[1271] Business interests are often sold to the IDGT at a purchase price that takes into account significant valuation discounts.[1272] Alternatively, one can redeem the stock by a closely held corporation in exchange for a private annuity.[1273] When interest rates are low, as they are today, private annuity sales offer significant estate tax savings because, upon the death of the annuitant, when properly structured, the transferred property is not includible in the estate.[1274]

In a private annuity sale, the valuation tables under section 7520 must be utilized.[1275] The valuation tables assume that the transferor, in a private annuity for life, receives the full payments according to his or her actuarial life expectancy.[1276] If the transferor dies before reaching his or her actuarial life

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1267. *See* I.R.C. § 736(b)(1) (2012).

1268. *See id.*

1269. *See id.* § 7520(a).

1270. *See id.* § 2702.

1271. Neil H. Weinberg & Paige K. Ben-Yaacov, *How to Give Away the Family Store—Lifetime Transfers of Family Business Interests*, A.B.A. 27–28 (2010), http://www.americanbar.org/content/dam/aba/publications/rpte_ereport/2010/june/te_weinberg_ben_yaacov.authcheckdam.pdf. The Treasury eliminated the income tax deferral associated with taxable private annuity sales, to nongrantor trusts, by requiring the immediate recognition of gain on any appreciated property exchanged for a private annuity. The amount received for the property equals the current fair market value of the annuity contract, determined under section 7520. *See* Treas. Reg. §§ 1.72-6(e) (as amended in 1987), 1.1001-1(j) (as amended in 2007). Of course, if the property has a high basis—for example, property included in the estate of a first spouse to die, immediately after the first spouse's death—a sale to individuals can be contemplated without capital gains tax. *See* Treas. Reg. § 25.2701-5(e)(3)(ii).

1272. *See* Treas. Reg. § 1.671-2 (as amended in 2000).

1273. *See* I.R.S. Priv. Ltr. Rul. 83-16-154 (Jan. 21, 1983); I.R.S. Priv. Ltr. Rul. 83-13-073 (Dec. 28, 1982); I.R.S. Priv. Ltr. Rul. 83-01-036 (Sept. 30, 1982); *s ee also* Fehrs Fin. Co. v. Comm'r, 487 F.2d 184 (8th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974).

1274. I.R.S. Gen. Couns. Mem. 39,503, issue 1 (May 7, 1986).

1275. *See* I.R.C. § 7520(c) (2012).

1276. *See id.*

expectancy, then the transferor has substantially depleted his or her gross estate.[1277]

2. *Exhaustion Test*

The Treasury regulations provide, in pertinent part:

> A standard Section 7520 annuity factor may not be used to determine the present value of an annuity for . . . the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to ensure that the annuity will be paid for the entire defined period. In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable Section 7520 interest rate at the valuation date of the transfer, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110.[1278]

This provision (also known as the "110 year exhaustion test"), applicable to lifetime terms, has the practical effect of forcing grantors to either: (i) limit the annuity term to the shorter of a term of years (determined by when the fund will be exhausted) or the prior death of the measuring life, or (ii) significantly "over funding" the trust with additional assets, above the determined charitable amount pursuant to the 110 year exhaustion test.[1279] Additionally, the Treasury regulations provide limitations with respect to the 110 year exhaustion test when there is "unproductive property" in the trust.[1280]

With the permanent increase of the Applicable Exclusion Amount to \$5.25 million per individual and the setting of the top transfer tax rate at 40%, the ability to "over fund" a CLAT at little or no transfer tax cost has dramatically increased, particularly for those individuals who live in states with no gift tax (all states other than Connecticut and Minnesota currently).[1281]

3. *Avoiding Section 2036*

Section 2036(a) provides:

> [t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full

1277. *See id.*
1278. Treas. Reg. § 1.7520-3(b)(2)(i) (as amended in 1996).
1279. *See id.* §§ 25.7520-3(b)(2)(v), ex. 5, 25.7520-3T(b)(2)(v), ex. 5.
1280. *See id.* §§ 25.7520-3(b)(2)(v), ex. 1, 25.7520-3T(b)(2)(v), ex. 1.
1281. *See* Deborah L. Jacobs, *IRS Raises Limit on Tax-Free Lifetime Gifts*, FORBES (Oct. 31, 2013), http://www.forbes.com/sites/deborahljacobs/2014/10/30/irs-raises-limit-on-tax-free-lifetime-gifts-for-2015/.

> consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.[1282]

The Service may attack private annuity sales under section 2036(a), especially under circumstances when the income corresponds exactly to the payments or the transferor retained a life estate.[1283] The key issue is whether the bona fide sale for an adequate and full consideration in money or money's worth exception applies.[1284]

Two revenue rulings illustrate the risk under section 2036(a) when the annuity equals the income of the transferred property.[1285] In Revenue Ruling 68-183, the grantor of a trust sold stock in a corporation having a fair market value of $700x in exchange for the trust's contractual obligation to pay him $40x each year for the rest of his life.[1286] The current income yield of the property held in the trust was said to equal $40x per year.[1287] The only funds available for making the annual payment to the grantor were those payments received as income by the trust.[1288] The Service ruled that, although the transaction purported to be a sale of the stock to the trust, in substance the transaction was a contribution of stock to the trust with the reservation of an income interest in the trust for life.[1289] Because all the income of the trust was used to make payments to the grantor, he was considered to be the owner of the trust under section 677(a) of the grantor trust rules, and the trust corpus would be included in his estate under section 2036.[1290]

In Revenue Ruling 79-94, the taxpayer transferred the right to income from an irrevocable trust to the children in return for the children's agreement to make annuity payments that were not less than the trust income or a specified amount that was less than the average trust income.[1291] The Service ruled that the trust corpus was includible in his gross estate under section 2036(a) because of the likelihood that the children would never have to make payments from

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1282. I.R.C. § 2036(a) (2012).
1283. *See id.*
1284. *See id.*
1285. *See* Rev. Rul. 68-183, 1968-1 C.B. 308; Rev. Rul. 79-94, 1979-1 C.B. 308; Rev. Rul. 79-94, 1979-1 C.B. 296.
1286. Rev. Rul. 68-183, 1968-1 C.B. 308.
1287. *See id.*
1288. *See id.*
1289. *See id.*
1290. *See id.*; I.R.C. § 2036 (2012).
1291. Rev. Rul. 79-94, 1979-1 C.B. 296.

their own funds and the decedent had received no consideration for the transfer.[1292]

There have been numerous cases on the issue of whether the transferor created a private annuity or made a transfer to a trust and retained a life interest. In *Weigl v. Commissioner*, the tax court addressed the issue of whether a taxpayer sufficiently controlled a trust to be treated as the trust's grantor for income tax purposes, as opposed to being the purchaser of a private annuity.[1293] The court cited several factors in distinguishing whether the transferor entered into an annuity transaction or a transfer in trust with a retained interest.[1294] Based upon these factors and the facts of the case, the court found that the taxpayer effectively controlled the trust in a number of ways and, thus, was the grantor of the trust—rather than having entered into a bona fide annuity transaction.[1295] The factors cited by the tax court include:

(a) the relationship between the creation of the trust and transfer of the property to the trust;

(b) the relationship between the income generated by the transferred property and the amount of the annuity payments;

(c) the degree of control over the transferred properties exercisable by the annuitant;

(d) the nature and extent of the annuitant's continuing interest in the transferred properties;

(e) the source of the annuity payment; and

(f) the arm's-length nature of the annuity/sale arrangement.[1296]

In *Ray v. United States*, the taxpayer argued that a private annuity resulted despite the fact that the trust agreement, on its face, purported to be a transfer in trust and not a sale in exchange for an annuity.[1297] In addition, the structure of the trust indicated an intent to preserve the principal of the property rather than, on an actuarial basis, exhausting all income and principal, as would be done in the case of an annuity.[1298] It was also clear that the transaction was structured so that the income of the trust would be the source of the payments to be made.[1299] In view of these facts, the court indicated that the entire substance of the transaction reflected an intent to establish a trust rather than a sale in exchange for an annuity.[1300]

The cases and rulings under section 2036 indicate that in order to avoid estate tax inclusion, the following factors would be helpful:

1292. *See id.*
1293. Weigl v. Comm'r, 84 T.C. 1192, 1225 (1985).
1294. *See id.*
1295. *See id.*
1296. *Id.*
1297. Ray v. United States, 762 F.2d 1361 (9th Cir. 1985), *aff'g*, 84-2 U.S.T.C. ¶ 13,584 (E.D. Wash. 1984).
1298. *Id*. at 1363.
1299. *Id.*
1300. *Id.*

(1) The annuity agreement should create a liability to the transferee that exists without regard to whether the property transferred produces income;

(2) The annuity payment is in an amount that substantially differs from any income that is produced by the transferred property; and

(3) The transferee should have assets in addition to those that were transferred in exchange for the annuity promise since adequate funding indicates a high probability of satisfying the payments.[1301]

The absence of some of the following factors has allowed the IRS to successfully recast a private annuity transaction as a transfer with a retained interest under section 2036(a):

(1) The transferor retained an interest in the transferred property;[1302]

(2) The transferee is not personally liable for the annuity payments;[1303]

(3) The annuity payments have been secured;[1304]

(4) The transferee has no independent financial means from which to make annuity payments;[1305]

(5) The annuity payments are identical or substantially similar to the income generated from the transferred assets;[1306] and

(6) The chance that the transferee would ever be called upon to make annuity payments from the transferee's own funds is remote.[1307]

If section 2036(a) applies, but the bona fide sale for adequate and full consideration exception exists, then the estate will only include the excess of the fair market value over the value of the consideration.[1308] In a technical advice memorandum, the National Office addressed whether private annuities received by a decedent in exchange for the transfer of real property before death constituted adequate consideration in money or money's worth.[1309] During the decedent's lifetime, after the decedent had suffered from a number of illnesses and physical ailments, the decedent transferred separate parcels of real property in exchange for a down payment of $10,000 and an annuity for the decedent's life.[1310] The decedent immediately forgave the entire down

1301. *See id.*; Rev. Rul. 69-74, 1969-1 C.B. 43; *Weigl*, 84 T.C. at 1225; Estate of Mitchell v. Comm'r, 43 T.C.M. (CCH) 1034 (1982) (ruling that transferred properties were included in the decedent's gross estate despite the fact that decedent's children never intended to pay the decedent any consideration due to their inability to pay the annuity).

1302. Fidelity-Phila. Trust Co. v. Smith, 356 U.S. 274 (1958); Becklenberg Estate v. Comm'r, 273 F.2d 297 (7th Cir. 1959), *rev'g*, 31 T.C. 402 (1958); Cain v. Comm'r, 37 T.C. 185 (1961), *acq.*, 1962-2 C.B. 4.

1303. Rev. Rul. 68-183, 1968-1 C.B. 308.

1304. 212 Corp. v. Comm'r, 70 T.C. 788 (1978); Estate of Bell v. Comm'r, 60 T.C. 469 (1973).

1305. *Estate of Mitchell*, 43 T.C.M. (CCH) 1034.

1306. Ray v. United States, 762 F.2d 1361, 1363 (9th Cir. 1985), *aff'g*, 84-2 U.S.T.C. ¶ 13,584 (E.D. Wash. 1984); Greene v. United States, 237 F.2d 848 (7th Cir. 1956); Lazarus v. Comm'r, 58 T.C. 854, 869 (1972), *acq.*, 1973-2 C.B. 2, *aff'd*, 513 F.2d 824 (9th Cir. 1975); Rev. Rul. 79-94, 1979-1 C.B. 296.

1307. *Greene*, 237 F.2d at 853; Rev. Rul. 79-94, 1979-1 C.B. 296.

1308. *See* I.R.C. § 2036(a) (2012).

1309. I.R.S. Tech. Adv. Mem. 95-13-001 (Mar. 31, 1995).

1310. *Id.*

payment.[1311] The children's actions did not indicate that any child made the next annual annuity payment, which was due one month before the decedent died a year later.[1312] The National Office advised that the value of the private annuities received by the decedent did not constitute adequate consideration for federal gift tax purposes.[1313]

VIII. CONCLUSION

The new tax environment has catapulted income tax planning, the step-up in basis, and tax basis management to the center of estate planning. This requires an adjustment in the mindset of estate planners who have become accustomed to looking only at the transfer tax consequences of estate planning. This may require the modification of pre-existing and traditional estate planning structures to accomplish new objectives in this new paradigm. For new plans, estate planning requires a careful assessment of the income tax benefits of the "step-up" in basis against the transfer tax costs of including the assets in the estate. With growing Applicable Exemption Amounts, maximizing the step-up will become an important tax savings tool for taxpayers. Proactive tax basis management can take many forms, from the simple to the complex; nonetheless, the income tax savings are undeniable.

1311. *Id.*
1312. *Id.*
1313. *Id.*

APPENDIX A

SUMMARY OF STATE INCOME AND DEATH TAX RATES (AS OF JULY 1, 2014)

State	State Income Tax[1314]	Top State Death Tax Rate[1315]	2014 State Death Tax Exemption[1316]
Alabama	5.00%	No state death tax	
Alaska	0.00%	No state death tax	
Arizona	4.54%	No state death tax	
Arkansas[1317]	4.90%	No state death tax	
California	13.30%	No state death tax	
Colorado	4.63%	No state death tax	
Connecticut (Estate & Gift Tax)	6.70%	12% (Estate & Gift Tax)	$2,000,000 (Estate & Gift Tax)
Delaware	6.75%	16.00%	$5,250,000 (Indexed for Inflation)
District of Columbia	8.95%	16.00%	$1,000,000
Florida	0.00%	No state death tax	
Georgia	6.00%	No state death tax	
Hawaii	11.00%	16.00%	$5,250,000 (indexed for inflation)
Idaho	7.40%	No state death tax	
Illinois	5.00%	15.70%	$4,000,000
Indiana	3.40%	No state death tax	Inheritance tax repealed in 2013
Iowa (Inheritance Tax)	8.98%	Inheritance Tax – No tax on lineal heirs	

1314. *State Individual Income Tax Rates, 2000-2014*, TAX FOUND., http://taxfoundation.org/article/state-individual-income-tax-rates (last visited Oct. 27, 2014).

1315. Joel Michael, *Survey of State Estate Inheritance and Gift Taxes*, RES. DEP'T MINN. HOUSE REPRESENTATIVES (Sept. 2014), http://www.house.leg.state.mn.us/hrd/pubs/estatesurv.pdf.

1316. *Id.*

1317. Taxpayers may exclude 30% of net, long-term capital gain for state taxes. The tax rate displayed is 70% of the state income tax rate. Arkansas State Revenue Tax Quarterly Vol. XIX, No. 4, ARK. DEP'T FIN. & ADMIN. (Oct./Nov./Dec. 2013), http://www.dfa.arkansas.gov/offices/policyAndLegal/Documents/quarterly2013-4.pdf.

Kansas	4.90%	No state death tax	
Kentucky (Inheritance Tax)	6.00%	Inheritance Tax – No tax on lineal heirs	
Louisiana	6.00%	No state death tax	
Maine	7.95%	12.00%	$2,000,000
Maryland (Estate & Inheritance Tax)	5.75%	16.00%	$1,000,000 (2014); $1,500,000 (2015); $2,000,000 (2016); $3,000,000 (2017); $4,000,000 (2018); and equal to the Federal Applicable Exclusion Amount in 2019 and thereafter. Inheritance Tax - No tax on lineal heirs
Massachusetts	5.25%	16.00%	$1,000,000
Michigan	4.25%	No state death tax	
Minnesota	9.85%	16% (Estate Tax)	$1,200,000 (2014); $1,400,000 (2015); $1,600,000 (2016); $1,800,000 (2017); $2,000,000 (2018 and thereafter). Gift tax repealed retroactively on March 21, 2014.
Mississippi	5.00%	No state death tax	
Missouri	6.00%	No state death tax	
Montana[1318]	4.90%	No state death tax	
Nebraska (County Inheritance Tax)	6.84%	1.00%	County inheritance tax
Nevada	0.00%	No state death tax	
New Hampshire[1319]	0.00%	No state death tax	

1318. Taxpayers can claim a capital gains tax credit against their Montana income tax up to 2% of their net capital gain. MONT. ADMIN. R. 42.4.502 (2010). The tax rate displayed is net of credit. *Id.*

1319. Five percent tax on interest and dividends only. *Overview of New Hampshire Taxes*, N.H. DEP'T REVENUE ADMIN., http://www.revenue.nh.gov/assistance/tax-overview.htm#inheritance (last visited Oct. 27, 2014).

New Jersey (Estate & Inheritance Tax)	8.97%	16.00%	$675,000; Inheritance Tax - No tax on lineal heirs
New Mexico[1320]	2.45%	No state death tax	
New York	8.82%	16.00%	$2,062,500 (4/1/2014-4/1/2015); $3,125,000 (4/1/2015-4/1/2016); $4,187,500 (4/1/2016-1/1/2019); and equal to the Federal Applicable Exclusion Amount in 2019 and thereafter. For estates valued at 105% or more of the basic exclusion amount, there is a phase-out so the estate would pay the same as it would have when the exclusion was $1,000,000.
New York City	12.70%	16.00%	$1,000,000
North Carolina	7.75%	No state death tax	Estate tax repealed in 2013
North Dakota[1321]	2.79%	No state death tax	
Ohio	5.93%	No state death tax	
Oklahoma	5.25%	No state death tax	
Oregon	9.90%	16.00%	$1,000,000
Pennsylvania (Inheritance Tax)	3.07%	4.50%	$3,500 (family exemption amount, may not apply in all circumstances)
Rhode Island	5.99%	16.00%	$910,725
South Carolina[1322]	3.92%	No state death tax	

1320. Taxpayers may deduct $1,000 or 50% of the net capital gains, whichever is greater. The tax rate displayed is net of 50% deduction. *State Treatment of Capital Gains and Losses, 2011*, TAX POLICY CENTER (Mar. 18, 2013), http://www.taxpolicycenter.org/taxfacts/content/PDF/state_capital_gains.pdf.

1321. Taxpayers may exclude 30% of net long-term capital gain for state taxes. The tax rate displayed is 70% of the state income tax rate. *Id.*

1322. "Net capital gains which have been held for a period of more than one year and have been included in [South Carolina] taxable income are reduced by 44% for [South Carolina] income tax purposes." *South Carolina Subtractions From Income*, TAX SLAYER, http://www.taxslayer.com/support/ 712/SC-subtractions-from-Income (last visited Oct. 27, 2014).

South Dakota	0.00%	No state death tax	
Tennessee[1323] (Inheritance Tax)	6.0% (on income from dividends, interest, and capital gain distributions from mutual funds). No income tax on other capital gain.	9.50%	Inheritance Tax - Top rate for lineal heirs is 9.5%-exemption $1.25 million (for 2013 deaths); increases to $2 million for 2014 deaths, $5 million for 2015 deaths, and is eliminated beginning in 2016.[1324]
Texas	0.00%	0.00%	No state death tax
Utah	5.00%	0.00%	No state death tax
Vermont[1325]	8.95%	16.00%	$2,750,000
Virginia	5.75%	0.00%	No state death tax
Washington	0.00%	20.00%	$2,000,000 (indexed against the consumer price index for the Seattle-Tacoma-Bremerton metropolitan area)
West Virginia	6.50%	0.00%	No state death tax
Wisconsin[1326]	5.43%	0.00%	No state death tax
Wyoming	0.00%	0.00%	No state death tax

1323. Six percent of state income tax on dividends and interest only. *Guidance for Tennessee's Hall Income Tax Return*, TENN. DEP'T REVENUE, http://www.tn.gov/revenue/taxguides/indincguide.pdf (last visited Oct. 27, 2014).

1324. TENN. CODE ANN. § 67-8-316(b) (2011), as amended by Tenn. Pub. Act Ch. 1057.

1325. A flat exclusion is allowed for capital gains held longer than three years equal to the lesser of $5,000 or 40% federal taxable income. *See State Treatment of Capital Gains and Losses, 2011, supra* note 1320.

1326. Taxpayers may exclude 30% of net long-term capital gain for state taxes. The tax rate displayed is 70% of the state income tax rate. *See id.*

APPENDIX B

NOTESONTHEWEALTHFORECASTINGSYSTEM

The Bernstein Wealth Forecasting System uses a Monte Carlo model that simulates 10,000 plausible paths of return for each asset class and inflation and produces a probability distribution of outcomes.[1327] The model does not draw randomly from a set of historical returns to produce estimates for the future.[1328] Instead, the forecasts (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of the analysis; and (4) factor in a reasonable degree of randomness and unpredictability.[1329]

The following chart demonstrates Alliance Bernstein's projected capital market and health forecasting in 2013.[1330]

Capital Market Projections & Notes on Wealth Forecasting System

	Median 20-Year Growth Rate	Mean Annual Return	Mean Annual Income	One-Year Volatility	20-Year Annual Equivalent Volatility
Municipal Cash	1.9	2.1	2.1	0.2	5.2
Cash Equivalents	2.7	3.0	3.0	0.3	7.1
Short Term Taxables	3.9	4.2	4.5	0.9	7.0
Int-Term Taxables	3.6	3.8	5.1	4.5	6.1
US Diversified	7.9	9.4	2.8	16.3	16.1
US Value	8.2	9.6	3.4	15.8	16.0
US Growth	7.6	9.5	2.3	18.2	17.5
US SMID	8.1	10.1	2.4	18.5	18.6
Developed International	8.7	10.6	3.9	17.9	17.1
Emerging Markets	6.8	10.7	3.7	26.6	26.3
Inflation	3.1	3.3	N.A	1.1	8.0

Notes:

The Bernstein Wealth Forecasting System uses a Monte Carlo model that simulates 10,000 plausible paths of return for each asset class and inflation; it produces a probability distribution of outcomes, based on Bernstein's estimates of the range of returns for the applicable capital markets over the appropriate time period. The model does not draw randomly from a set of historical returns to produce estimates for the future. Instead, the forecasts (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of the analysis; and (4) factor in a reasonable degree of randomness and unpredictability.

"Global Equities" is defined as 21% US Diversified, 21% US Value, 21% US Growth, 7% US SMID, 22.5% Developed International, 7.5% Emerging Markets.

Does not represent any past performance and is not a guarantee of any future specific risk-levels or returns, or any specific range of risk-levels or returns.
Based on 10,000 simulated trials each consisting of 20-year periods.
Reflects Bernstein's estimates, and the capital market conditions of March 31, 2013.

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