**BASIS PLANNING AND ANOMALIES
WITH PARTNERSHIPS, GRANTOR TRUSTS,
AND UNITARY BASIS**

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I. INTRODUCTION

A. Focus of These Materials

1. Tax basis and realization are fluid concepts in the world of partnership taxation, especially when one considers the "unitary basis" rule and how a grantor, grantor trust, and disregarded entity are treated as the same taxpayer. In such a world, entities taxed as partnerships (and disregarded entities) provide the most sophisticated platform to exchange assets and strip, shift, create, combine, and concentrate basis. These materials will explore these concepts through the lens of common estate planning situations, with an eye toward possible legislative changes in the future.

2. These materials are being prepared in conjunction with a set of materials titled, "Conquering Subchapter K(ryptonite): Fundamentals of Partnership Taxation for Estate Planners"[1] (hereinafter referred to as, "Subchapter K(ryptonite) Outline"). Some portions of the Subchapter K(ryptonite) Outline have been modified and expanded for these materials. In addition, to avoid unnecessary duplication, these materials will make section references to the Subchapter K(ryptonite) Outline when appropriate.

B. *Rothstein*, Revenue Ruling 85-13, and Proposed Section 1062

1. In *Rothstein v. United States*,[2] the taxpayer held 300 shares of a corporation that built warehouses for rental. The taxpayer contributed the shares to an irrevocable trust for the benefit of his three children. The taxpayer's wife was the trustee. A few years later, the taxpayer purchased the remaining 300 shares held by the other shareholder for $500,000, to be paid at a later date. Soon thereafter, the taxpayer then purchased from the trust the 300 shares he had originally contributed in exchange for an "unsecured promissory note" (in actuality, an installment note) for a principal amount of $320,000, bearing interest at 5%. A few months later, the taxpayer who now owned 100% of the shares of the corporation, dissolved the corporation, with all of the property of the corporation distributed to the taxpayer in liquidation. The taxpayer then replaced and refinanced the existing $200,000 mortgage with a $700,000 mortgage and used the excess $500,000 of loan proceeds to pay the other shareholder. On the taxpayer's return, the taxpayer claimed deductions for $16,000 in interest on the promissory note to the trust and a short-term capital loss of $33,171 on the liquidation of the corporation.[3]

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[1] Attachment A to this Outline.

[2] *Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984).

[3] Amount realized by the taxpayer is fair market value of the liquidated property of $1,054,580, reduced by assumed corporate liabilities of $267,751 (net $785,829), with a cost basis in the stock of $820,000 ($500,000

2. The IRS assessed a deficiency against the taxpayer based on a disallowance of the interest deduction and based upon a position that the liquidation resulted in a gain, not a loss. The IRS based both conclusions on the contention that the irrevocable trust was a grantor trust under section 675(3) of the Code. The foregoing provides that a grantor trust status is created if "[t]he grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor."[4] If the trust is a grantor trust, then under section 671 of the Code the grantor is treated as the "owner" of the property. As such, the IRS argued, the interest deduction should be disallowed, the sale by the trust should be ignored for income tax purposes, and as a result, the basis of the shares in the corporation on liquidation should be reduced by $320,000.

3. The court agreed that the trust was a grantor trust under section 675(3). However, notwithstanding that, the court held for the taxpayer. In coming to that conclusion it examined what "ownership" under the grantor trust rules means. To wit, section 671 of the Code provides:

> Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.[5]

Pursuant to a strict reading of the foregoing, the court concluded that "ownership" means that the trust's income, deductions, and credits will be attributed to the grantor. As stated by the court:

> Section 671 makes it plain that it was not Congress's intention that the taxation of grantor/"owners" be governed by what might otherwise seem the sensible general principle that a taxpayer may not have meaningful dealings with himself. Rather, the statute envisions (1) that the income and deductions of the grantor and the trust will be computed in the normal fashion, the trust being treated as a fully independent taxpaying entity, and (2) that the relevant "items of income, deductions, and credits against tax" that would ordinarily appear on the trust's return will instead "be included in computing the taxable income and credits of the grantor". Nowhere does § 671 direct that the grantor's basis in property purchased from the trust be deemed any different from what it would otherwise be, namely, his cost in acquiring it—in this case $320,000, the amount of taxpayer's note. Nor does the statute contain anything authorizing the Commissioner to disallow an interest deduction on the ground that grantor's payments were made to the trust. Consistently with the objective of *Clifford* to prevent high-bracket taxpayers from

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from the stock purchased from the other shareholder, and $320,000 on the stock purchased from the trust). *Id.* at 705.

[4] § 675(3) of the Internal Revenue Code of 1986, as amended (the "Code"). Hereinafter, all section references denoted by the symbol § shall refer to the Code, unless otherwise noted.

[5] § 671.

shifting income to low-bracket trusts over which they retain or exercise excessive controls, § 671 dictates that, when the grantor is regarded as "owner", the trust's income shall be attributed to him—this and nothing more.[6]

4. Echoing the *Rothstein* ruling, Professor Jeffrey N. Pennell writes, as to grantor/grantor trust transactions being ignored for income tax purposes:[7]

> The Code and Regs, however, are not entirely consistent with that treatment. Instead, every grantor trust rule (§§673-677) begins by saying "The grantor shall be treated as the owner of any portion of a trust . . ." The significance of this is found in §671:
>
> > Where it is specified . . . that the grantor . . . shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor . . . those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.
>
> Notice that this does not mention losses, which are considered along with gains only in determining the trust's income. This also does not say that an exchange with a grantor trust is not recognized, or that the trust is ignored…
>
> In a nutshell, then, the tax attributes of a grantor trust are reported by the grantor on the grantor's income tax return, as if the trust's income (which includes net gain in excess of any offsetting losses), deductions, and credits belonged to the grantor.
>
> The actual treatment, however, is as if the trust's DNI was entirely taxable to the grantor. Losses would offset gains in the trust for this purpose, and gain that is attributed out to the grantor thus would be less. But excess losses are trapped in the trust by virtue of the rule in §642(h) ... And these results apply only to the extent the grantor is treated as the owner of the trust. It is not necessarily true for the entire trust, depending upon application of the portion rules.
>
> As a result, the conclusion articulated by various authorities that the trust is "ignored" is not what either the Code or Regulations themselves actually specify. Yet the government itself makes pronouncements that are interpreted by taxpayers in a vast number of different situations to mean that a grantor trust is treated as if it did not exist. This especially is true involving transfers by a grantor into an intentionally defective grantor trust, based on the government's ruling position that the grantor can have no gain or loss on a transfer involving the grantor trust — that an exchange between the grantor and the trust is not a gain or loss realization event.

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[6] *Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984), at 709.

[7] *Jeffrey N. Pennell*, (Mis)Conceptions about Grantor Trusts, 50th Annual Southern Federal Tax Institute, Outline V, p. 1-2 (Oct. 2015).

5. Notwithstanding the foregoing, the IRS issued Revenue Ruling 85-13,[8] and on facts similar to *Rothstein*, the IRS ruled the taxpayer in question did not obtain a new cost basis when he purchased the assets from the grantor trust. Specifically, the ruling provides:[9]

> In Rothstein, as in this case, section 671 of the Code requires that the grantor includes in computing the grantor's tax liability all items of income, deduction, and credit of the trust as though the trust were not in existence during the period the grantor is treated as the owner. Section 1.671-3(a)(1) of the regulations. It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.
>
> The court's decision in Rothstein, insofar as it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor, is not in accord with the views of the Service.

6. The estate planning implications of Revenue Ruling 85-13 are far reaching. Most notably, it has given rise to installment sales to intentionally defective grantor trusts (IDGTs)—trusts that are grantor trusts for income tax purposes but the assets of which will not be includible in the estate of the grantor.[10] Installment sales to IDGTs allow grantors to "sell" appreciated assets, often with valuation discounts applied to the purchase price, in exchange for an installment note bearing interest at the applicable federal rate (AFR).[11] The estate planning result of this transaction is the grantor owning an asset that is "frozen" in value (principal amount of the note, the return on which is generally at a low interest rate) and all future appreciation on the asset removed from the gross estate of the grantor. All of this is accomplished without any income tax implications as long as the grantor is still alive and grantor trust status is maintained at least until the note is satisfied. It has also given rise to transactions between beneficiaries and their

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

[9] *Id. See also* Rev. Rul. 2007-13, 2007-1 C.B. 684 (sale of a life insurance policy from one grantor trust to another grantor trust is not a transfer for income tax purposes because the grantor is treated as the owner of the assets of both trusts)), Rev. Rul. 88-103, 1988-2 C.B. 304 and PLR 8729023 (grantor and grantor trust will be treated as a single taxpayer for purposes of qualifying for involuntary conversion treatment under section 1033 of the Code), and Rev. Rul. 2004-86, 2004-33 I.R.B. 191 (a taxpayer may exchange interests in a grantor trust—a Delaware statutory trust—for real property and qualify for like-kind treatment under section 1031 of the Code). *But see* Prop. Treas. Reg. § 1.108-9(c)(1), (2) (cancellation of indebtedness rules only apply if the grantor, not the grantor trust, is bankrupt or insolvent).

[10] *See, e.g.,* Stuart M. Horwitz & Jason S. Damicone, *Creative Uses of Intentionally Defective Irrevocable Trusts*, 35 Est. Plan. 35 (2008) and Michael D. Mulligan, *Sale to Defective Grantor Trusts: An Alternative to a GRAT*, 23 Est. Plan. 3 (1996).

[11] § 1274.

beneficiary deemed owner trusts[12] (BDOTs) or beneficiary deemed inheritor's trust (BDITs)[13]—trusts the assets of which are not includible in the estate of the beneficiary but which are deemed "owned" by the beneficiary under section 678 of the Code.[14] Unless and until the IRS revokes Revenue Ruling 85-13 (or a law is enacted that changes the disregarded nature of these transactions), it is obligated to follow its published rulings.[15]

7. On September 13, 2021, the House Ways and Means Committee introduced a draft of a tax bill (as part of the Build Back Better plan) that included a new section 1062 of the Internal Revenue Code of 1986, as amended (the "Code"), which applies to certain transactions between "deemed owners" and their deemed-owned trusts and which would effectively revoke Revenue Ruling 85-13. Although section 1062 of the Code is currently not included in the subsequent reconciliation bills up for consideration at the time of the preparation of these materials, it does give some insight into how the Treasury Department and the IRS might seek to limit transactions between grantors and other deemed owners and their deemed owned trusts in the future. If section 1062 or a similar provision becomes law, entities taxed as partnerships may become even more critical in estate planning, and certain transactions between grantors, grantor trusts, and their partnerships that are currently non-taxable may become taxable events.

8. The proposed section 1062 provided, "In the case of any transfer of property between a trust and the [sic] a person who is the deemed owner of the trust (or portion thereof), such treatment of the person as the owner of the trust shall be disregarded in determining whether the transfer is a sale or exchange for purposes of this chapter."[16] A "deemed owner" means "any person treated as the owner of a portion of trust under subpart E of part 1 of subchapter J" (sections 671 through 679 of the Code, dealing with grantors and other treated as substantial owners). The provision effectively creates a fiction that when such transfers occur between a deemed owner and his or her deemed-owned trust, the two parties will be treated as separate taxpayers.[17] However, for all other purposes, grantor trust status is respected and in effect.

9. Section 1062 would cause certain transactions (e.g., sale of assets to an IDGT, payments on IDGT installment obligations, and a "swap" of assets) to be recognition events for income tax purposes. As written, for it to apply, there needs to be a "transfer" of property between

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[12] *See* Edwin P. Morrow, *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)* (April 19, 2018). Available at SSRN: https://ssrn.com/abstract=3165592 and Jonathan G. Blattmachr, Mitchell M. Gans, and Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106 (2009).

[13] *See* Jerome M. Hesch, Lawrence Brody, Richard A. Oshins & Susan P. Rounds, *A Gift From Above: Estate Planning on a Higher Plane — The Unique Design of a BDIT Minimizes — Even Eliminates — Many Tax and Non-Tax Problems*, 150 Tr. & Est. 17 (Nov. 2011).

[14] The IRS has section 678 beneficiary owned trust on its list of areas in which rulings will not ordinarily be issued and list of areas under study in which rulings will not be issued until the service resolves the issue through the publication of a revenue ruling, revenue procedure, regulation, or otherwise. Rev. Proc. 2021-3, 2021-1 I.R.B. 140, sections 4.01(42) and 5.01(10).

[15] *See Rauenhorst v. Commissioner*, 119 T.C. 157 (2002).

[16] Section 138209 of the September 13, 2021, House Ways and Means Committee proposal for H.R. 5376, which was modified on October 28, 2021, and November 3, 2021, and in both modifications, the proposal for section 1062 was omitted (along with a corresponding transfer tax provision, section 2901).

[17] The proposal also included an amendment to the related party rules under section 267 of the Code disallowing losses between a grantor trust and the person treated as the owner of the trust under section 671 through 679, thereby negating the result in *Rothstein*.

a trust and a person who is the deemed owner of the trust. Furthermore, for a taxable event to occur, that "transfer" would also need to be considered a taxable sale or exchange, as opposed to a non-taxable exchange. This second requirement is significant. For example, under the Treasury Regulations, an exchange of property constitutes a "disposition of property"[18] under section 1001(a) of the Code (gain or loss is realized from the exchange) if the property being exchanged differs "materially either in kind or in extent."[19] The Supreme Court has interpreted the foregoing to mean that properties will be "materially different" if holders of the property enjoy "legal entitlements that are different in kind or extent."[20] As such, even if section 1062 became law, if a grantor exchanges high basis assets in corporation X for low basis assets in corporation X held by an IDGT, then the exchange would not be taxable under proposed section 1062.

C. Grantors, Grantor Trusts, Partnerships, and Disregarded Entities

1. As noted above, section 1062 does not revoke the grantor trust rules, and there seems no appetite in Congress to do so. So long as the grantor trust rules remain, grantors and the assets owned by their grantor trusts, will be deemed to be the same taxpayer (although taxable transactions between them might be taxable under section 1062 or other similar provision in the future). In the context of partnerships, this means that deemed owners and their deemed-owned trusts are treated as the same taxpayer. The consequences of this are significant. For example, if a grantor and an IDGT are partners in a partnership and the IDGT contributes property to the partnership, then the grantor is treated as the contributing partner. As such, distributions of the contributed property from the partnership to the grantor do not implicate the mixing bowl rules because this is effectively a distribution back to the contributing partner (although, counterintuitively, the distribution may be considered a disguised sale).[21] Furthermore, as discussed in detail in the next section, this also means that the grantor and IDGT will share the "unitary" combined outside basis of the partners.

2. In the context of limited liability companies (LLCs), when a deemed owner and his or her deemed-owned trust are the only members of the LLC, then the default federal income tax classification of the LLC is a "disregarded entity."[22] The practical effect of this classification is that the deemed owner, the deemed-owned trust, and the LLC are treated as a single taxpayer. As such, all transactions between the three persons will be ignored for federal income tax purposes. This provides considerable flexibility among the parties to transfer assets between and among them without any federal income tax consequences. However, if section 1062 or other similar provision becomes law, such transfers could be considered taxable sales or exchanges.

II. UNITARY BASIS RULE: PLANNING POSSIBILITIES & PERILS

A. Introduction to the Unitary Basis Rule

1. Estate planners are often surprised to learn that each partner in a partnership has a "unitary basis" in his or her partnership interest, even if the partner has different classes of partnership interest (general and limited, preferred and common, etc.) and even if the partner

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[18] § 1001(a).

[19] Treas. Reg. § 1.1001-1(a).

[20] *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991) , at 565.

[21] *See* II.F.4. and II.F.5. of the Subchapter K(ryptonite) Outline.

[22] *See* IV.A.1. of the Subchapter K(ryptonite) Outline.

acquired the partnership interests in different transactions.[23] This is in stark contrast to the "separate lot" rules applicable to shares of corporate stock when such separate lots can be "adequately identified."[24]

2. The unitary basis rule is based and explained in Revenue Ruling 84-53,[25] which described four different situations involving the sale of a partnership interest, three of which involve liability shifts. The underlying authority for the position taken in the ruling is section 1.61-6(a) of the Treasury Regulations, which provides:

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

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

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

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

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

4. Situation 1

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

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

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

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

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

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

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

5. Situation 2

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

b. The tax consequences of B’s sale of B’s limited partnership interest to A are the same as situation 1.

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

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

6. Situation 3

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

b. The tax consequences of B’s sale of B’s limited partnership interest to A are the same as situation 1.

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

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

7. Situation 4

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

b. The tax consequences of B’s sale of B’s limited partnership interest to A are the same as situation 1.

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

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

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

> In cases where the partner's share of all partnership liabilities does not exceed the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the transferor partner shall first exclude from the adjusted basis of such partner's entire interest an amount equal to such partner's share of all partnership liabilities, as determined under section 1.752-1(e) of the regulations. A part of the remaining adjusted basis (if any) shall be allocated to the transferred portion of the interest according to the ratio of the fair market value of the transferred portion of

> the interest to the fair market value of the entire interest. The sum of the amount so allocated plus the amount of the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest (under section 752(d) of the Code and section 1.1001-2 of the regulations) equals the adjusted basis of the transferred portion of the interest.
>
> On the other hand, if the partner's share of all partnership liabilities exceeds the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the adjusted basis of the transferred portion of the interest equals an amount that bears the same relation to the partner's adjusted basis in the entire interest as the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest bears to the partner's share of all partnership liabilities, as determined under section 1.752-1(e).

9. Unitary basis is determined on a partnership-by-partnership basis even, so it seems, if a partner has an interest in 2 or more partnerships that are identical in all respects (including the interests of other partners), except perhaps the assets in the partnership, there does not seem to be a statutory rule that the unitary basis of the partner must be aggregated. This may have important planning implications in estate planning as it bears to reason that it might make sense for taxpayers to segregate low basis and high basis assets into different partnerships.

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

1. Generally

a. As discussed above, Revenue Ruling 85-13 provides that a grantor will be treated as the owner of all assets in a grantor trust, and as such, the trust is not a separate taxpayer from the grantor. The deemed-owned trust and the deemed owner are a single taxpayer. From a unitary basis standpoint this means that if the deemed owner and the deemed-owned trust are partners in a partnership, they are deemed to have a unitary basis in their combined partnership interests.

b. Outside basis determines, among other things, the amount of money a partnership can distribute to a partner without triggering gain.[26] In addition, section 704(d) of the Code provides that a partner’s distributive share of partnership losses is allowed only to the extent of the partner’s outside basis at the end of the partnership taxable year in which the loss occurred. Any loss in excess of the partner’s outside basis is suspended until such time as there is sufficient outside basis. Unitary basis allows a deemed owner and a deemed-owned trust to combine and share the outside basis. In the context of family-owned partnerships, it is unusual to have special (disproportionate) allocations of tax items (i.e., losses) to one partner. However, disproportionate distributions that reduce a partner’s interest (i.e., partial redemption of a partner’s interest) are common. This would allow, for example, a deemed owner and deemed-owned trust to use the combined unitary basis for the benefit of one partner over the other.

> Example: G and G’s grantor trust (T) are equal partners of GT Partnership. GT Partnership has an additional 1% partner that is ignored for purposes of this example. Both G and T have an outside basis in their respective partnership interest of $30x and a capital account balance of $100x. Thus, G and T have a

[26] *See* § 731(a).

unitary basis of $60x. GT Partnership makes a disproportionate distribution of a partnership asset that has an inside basis of $50x and a fair market value of $50x to T, reducing T's partnership interest by one-half (T's capital account is reduced to $50x). After the distribution, T's interest in GT goes from 50% to a 33.3% interest, and T holds the distributed asset with a basis and fair market value of $50x. G and T's remaining unitary basis is $10x. G's capital account is $100x, and T's capital account is $50x.

If T is a grantor trust the assets of which will not get a "step-up" in basis on the death of the grantor, then this is an indirect way of allowing T to get the benefit of G's outside basis. Certainly, this type of basis management could have been accomplished with a "swap" power under section 675(4)(C) of the Code, but if proposed section 1062 or other similar provision becomes law, this is a non-taxable way to get a similar result.

c. Not only does Revenue Ruling 85-13 have unitary basis implications, it also means that if, for example, a deemed owner makes a contribution of property to a partnership and the partnership then distributes the property to the contributor's deemed-owned trust, this transfer is effectively treated as a distribution back to the contributing partner (because the deemed owner and the deemed-owned trust are treated as the same taxpayer). The ramifications of this combination of Revenue Ruling 85-13 and the unitary basis rule are seemingly limitless.[27] Some of these implications are explored herein.

2. Contributions and Distributions

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

b. As discussed in II.F.2. of the Subchapter K(ryptonite) Outline, liquidating distributions can result in gain *or loss*, and if property is distributed in liquidation of a partner's interest, then the adjusted basis of the distributed property in the hands of the distributee can be equal to, lower than, or *greater than* the inside basis of the property prior to the distribution. In contrast, as discussed in II.F.1. of the Subchapter K(ryptonite) Outline, non-liquidating "current" distributions can only result in gain (not loss), and if property is transferred as part of a current distribution, then the adjusted basis of the distributed property in the hands of the distributee can be equal to or lower than the inside basis of the property prior to the distribution. In other words, current distributions of property can result in a reduction of basis on distributed property, but a liquidating distribution of property can result in a reduction and increase in basis on the property.

c. In the context of grantors and grantor trusts, if a grantor redeems his or her entire interest in a partnership for property but an IDGT continues to have an interest in the

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

partnership, it means that the distribution is considered a current distribution, rather than a liquidating distribution (because the grantor is deemed to still have an interest in the partnership). This could mean the grantor would not be able to take a capital loss upon exiting the partnership, and it might affect the basis that the grantor has in the distributed property.

> Example: G and G's grantor trust (T) are partners in GT Partnership. GT Partnership has an additional 1% partner that is ignored for purposes of this example. G's outside basis and capital account balance are $60x and $50x respectively. T's outside basis and capital account balance are $5x and $50x respectively. G and T's shared unitary basis and combined capital account balances are $65x and $100x. G is leaving the partnership, and to that end, GT partnership will redeem G's interest by making a distribution to G having a value equal to G's capital account balance of $50x.
>
> If GT distributes $50x of cash to G, G will not recognize any gain because G (without regarded to unitary basis) has sufficient outside basis to absorb the distribution (G's outside basis is reduced to $10x). Although G is no longer a partner in GT Partnership, G will not be able to recognize a loss because G is the deemed owner of the assets of T, and T is still a partner in GT Partnership. After the liquidation, it seems that T's outside basis is increased to $15x and capital account is $50x.
>
> If, instead, GT Partnership distributes an asset that has an inside basis of $30x and a fair market value of $50x, the distribution will be treated as a non-liquidating "current" distribution even though G is leaving the partnership because T is still a partner in GT Partnership. As such, the distribution will be non-taxable but the asset will have an adjusted basis of $30x in G's hands (instead of $60x if this was a liquidating distribution). G's outside basis will be reduced to $20x, and after the liquidation it seems that T's outside basis will be increased to $25x (and a capital account that remains at $50x).
>
> If G wishes to recognize a loss on the distribution of $50x to G, G could convert T to a non-grantor trust. As discussed later, assuming there are no partnership liabilities or other debts, this conversion would not be a taxable event. Upon conversion, the unitary basis rule is no longer applicable, and the liquidating distribution of $50x of cash to G may allow G to recognize a -$10x capital loss, assuming G's resulting outside basis is $60x after conversion. On the other hand and discussed later, the conversion may result G having only $32.5x in outside basis, which would then mean the liquidating distribution of $50x will result in $17.5x of gain. It seems the latter result, as unusual as it may seem, may be the right answer.

3. Disguised Sale and Mixing Bowl Implications

a. As discussed in II.F.5. of the Subchapter K(ryptonite) Outline, if a partner contributes appreciated property to a partnership and, generally within two years of the contribution, such contributing partner receives a distribution of any other property or cash, then the partner will recognize gain with respect to the contributed property under the "disguised sale" rules. Practitioners may be lulled into thinking that because Revenue Ruling 85-13 treats deemed owners and deemed-owned trusts as the same taxpayer that the disguised sale rules are not applicable. That is not the case unfortunately. As discussed in Subchapter K(ryptonite) Outline,

there are three types of disguised sales: (i) sales of property by a partner to the partnership; (ii) sales of property by the partnership to a partner; and (iii) a sale of a partnership interest by one partner to another partner. Only the latter would be exempt from disguised sale treatment if such sale occurred between a deemed owner and deemed-owned trust.[28] The other two disguised sales involve the partnership, which is a separate taxpayer (notwithstanding that the partnership itself is not subject to income tax).[29]

> Example: G, G's grantor trust (T), and 1 other person are partners in GT Partnership. The third partner has a 1% interest in GT Partnership, but this 1% interest is ignored for purposes of this example. Ignoring this 1% interest, G and T each own a 50% interest in GT Partners. G contributes $100x cash to the partnership, and T contributes property with an adjusted basis of $30x and fair market value of $100x (in exchange for additional partnership interests, but each still holding a 50% interest in GT Partnership). Soon after these contribution, the partnership transfers the contributed property to G.
>
> Assuming this is a disguised sale, this is treated as a sale of the contributed property by the partnership to G in a transaction where G is not treated as a partner.[30] The partnership is treated as having sold the contributed property, the gain of which is allocated to T because this is section 704(c) property (rather than to all of the partners under section 704(b)).[31] This is not treated as a distribution of property to G in his or her capacity as a partner. Ignoring time value of money, $70x of gain is recognized on the sale. G holds the property with a cost basis of $100x with a new holding period. The unitary basis shared between G and T will be increased by $70x. Note: if more than two years passes between the contributions and the distribution, then the transaction would most likely not be considered a disguised sale.
>
> If, prior to these contributions, T had exchanged the property for $100x cash, under Revenue Ruling 85-13 there would be no gain. The property would be held by G with a carryover holding period and an adjusted basis of $30x. G and T could then contribute the property and cash to the partnership without any gain. Query: because the disguised sale rule is determined on a facts and circumstances test, should the original transaction above should be a taxable disguised sale at all?
>
> If the entity was, instead, a LLC, and G and T were the only members, then such entity would by default be a disregarded entity. Any transfers to or from the LLC would be ignored and there would be no gain. Note, however, if proposed section 1062 or other similar provision becomes law, then there would be a taxable event and $70x gain would result.

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

[29] *See* § 701.

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

[31] *See* II.L.1. of the Subchapter K(ryptonite) Outline.

b. As discussed in II.F.4. of the Subchapter K(ryptonite) Outline, a "mixing bowl transaction" occurs (resulting in gain or loss), when a partner contributes appreciated (or loss) property to a partnership and within 7 years, either: (1) the contributed property is distributed to *another partner*, or (2) property *(other than the contributed property)* is distributed to the contributing partner. Because Revenue Ruling 85-13 treats deemed owners and deemed-owned trusts as the same taxpayer, when one partner makes a contribution of property and such property is distributed to the other partner, even within 7 years of contribution, neither of the mixing bowl triggers can occur. Both the deemed owner and the deemed-owned trust are treated as the contributor, regardless of which partner actually makes the contribution (in other words the contributed property is not contributed to "another partner"). Further, when the contributed property is distributed to the other partner, because the other partner is treated as the contributor, it is treated as if the contributed property is being distributed to the contributing partner. Note that when a mixing bowl transaction occurs it is an allocation of pre-contribution gain, not a transaction between partners. This distinction will be critical if proposed section 1062 or other similar provision becomes law as there is no "transfer" between the deemed owner and deemed-owned trust, which is required under section 1062.

4. Partnership Liabilities

a. As discussed in II.G. of the Subchapter K(ryptonite) Outline, partnership liabilities increase the outside basis of the partner who bears the economic risk of loss if the liability is a recourse, and if the liability is nonrecourse, then the outside basis increase is shared proportionately among all of the partners. Any increase in a partner's share of liabilities (including any assumption by a partner of any partnership liabilities) is treated as a contribution of money by the partner to the partnership, thereby increasing basis.[32] Any decrease is treated as a distribution of money to the partner, thereby reducing basis and possibly resulting in the recognition of gain if the amount of the deemed distribution exceeds available outside basis.[33]

b. An extension of the unitary basis rule is that a partner (i.e., deemed owner and his or her deemed-owned trust) will have one unitary liability allocation amount under section 752 of the Code. In a technical advice memorandum,[34] the IRS concluded that the deemed distribution under section 752(b) of the Code from a reduction in a partner's share of nonrecourse liabilities should be applied against the partner's entire basis in both its limited and general partnership interests. The limited partnership interests of two partners, A and B, each having both a general partner and a limited partnership interest, were liquidated. As a result of the liquidation of the limited partnership interests, the nonrecourse liability allocation of A and B decreased. The IRS agent argued that A and B each had a separate basis as a limited partner and as a general partner and that to the extent the decrease in liability allocation exceeded their basis in the limited partnership interests, they would recognize gain under section 731 of the Code. The IRS National Office disagreed with the agent, specifically stating that A and B had a single adjusted basis with respect to their interests in the partnership. Because each of A and B had a basis in the partnership exceeding the amount of money deemed to be distributed under section 752(b) of the Code, the liquidation of their limited partnership interests did not result in gain recognition to either A or B under section 731 of the Code.

[32] § 722 and Treas. Reg. § 1.752-1(b).

[33] §§ 733, 731(a), 751 and Treas. Reg. § 1.752-1(c).

[34] TAM 8350006.

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

Example: G and G's grantor trust (T) are partners in a partnership. G and T each have a 20% interest in the partnership, and each of them have an outside basis in the partnership of $10x and a capital account of $20x. The partnership has $30x of nonrecourse liabilities, and G and T's proportionate share of those liabilities is $6x each. The partnership is going to liquidate T's interest in the partnership by distributing $20x in cash. Under section 752(b), T's departure from the partnership causes T's share of partnership liabilities to decrease, and there is a deemed distribution of money equal to $6x. If the unitary basis rule did not apply, that would reduce T's outside basis to $4x, and the distribution of $20x to T would result in $16x of gain under section 731(a). However, with the unitary basis rule, outside basis starts at $20x (not $10x), reduced by $6x for the reduction in partnership liabilities under section 752(b), and then further reduced by $20x under section 731(a). The liquidation results in $6x of gain (not $16x).

G's resulting outside basis in the partnership is not $0x, because the liquidation of T causes G's percentage ownership to increase from 20% to 25%. The incremental increase in partnership interest (+5%) increases G's resulting outside basis to $1.5x (5% of $30x of nonrecourse liabilities). Of course, if G's partnership interest is included in G's estate, then the partnership interest will get a step-up in basis under section 1014. Further, if the partnership has a section 754 election in place, the basis of the assets inside the partnership will get an upward inside basis adjustment under section 743, as discussed in II.M.2. of the Subchapter K(ryptonite) Outline.

5. Conversions of Grantor and Non-Grantor Trusts

a. Generally

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

(2) If the change in ownership is treated like a gift, then the receipt of the trust property is not income to the recipient, and the property will have a carryover basis under section 1015 of the Code? If the change in ownership is caused by the death of the grantor, then

like bequests or other transfers at death, do the trust assets get a basis adjustment under section 1014 of the Code? Could the change in ownership be considered a taxable sale or exchange, with gain and possibly loss recognition? Or could this transfer of ownership be akin to a tax free exchange? If the change in ownership is not a taxable event, if debt is in excess of basis, do the holdings in *Crane v. Commissioner*[35] and *Commissioner v. Tufts*[36] require gain recognition?

b. Grantor to Non-Grantor Trust During Grantor's Lifetime

(1) In Revenue Ruling 77-402,[37] the IRS held that when grantor trust is terminated during the grantor's lifetime, the grantor is deemed to have transferred the trust property to a separate taxable entity. If the transferred property is subject to debt and the debt is in excess of basis, then the grantor, as the transferor, will recognize gain. In the ruling, A, an individual, created a T, an irrevocable trust (IDGT for the benefit of A's descendants) which is a grantor trust as to the entire trust due to certain retained powers. A contributed some funds to T, and the trustee used those funds to purchase a partnership interest in P, a partnership with a principal activity of investing in real property, using both recourse and nonrecourse financing. P elected accelerated depreciation. The resulting deduction were allocated to the partners of P, including T and in turn, deducted on A's income tax returns.

(2) When the adjusted basis of the partnership interest was nearly zero (deductions and other losses are limited to the amount basis in the partnership interests) and the real property had started generating net income, A, as grantor, renounced the powers that made T a grantor trust. The IRS ruled, "at the time A renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust, with the result that A was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, A is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor, A."[38]

(3) When a partner transfers an interest in a partnership and the transferor's share of partnership liabilities are reduced or eliminated, the transferor is treated as having sold the partnership interest for an amount equal to the amount of reduced or eliminated liabilities. The IRS thus concluded, "A realized an amount equal to the share of partnership liabilities that existed immediately before T converted from grantor to nongrantor status for Federal income tax purposes. The gain or loss realized by A is the difference between the amount realized from the reduction of the share of P's liabilities and the adjusted basis in the partnership interest … immediately prior to the change in T's tax status."[39] The ruling went on to say, the result would be the same if the termination of grantor trust status occurred due to the expiration or lapse of the powers or due to the exercise, release, renunciation, expiration or lapse of certain powers held by party other than the grantor.

(4) In 1980, the IRS issued section 1.1001-2 of the Treasury Regulations which addressed the discharge of liabilities in determining gain or loss on a sale, exchange, or other disposition. The Treasury Regulations provide, "the amount realized from a

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

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

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

[38] *Id.*

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

sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."[40] In particular, the Treasury Regulations provide the following special rules:[41]

> --(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;
>
> --(ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);
>
> --(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;
>
> --(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and
>
> --(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

(5) These Treasury Regulations also include an example[42] that is similar to Revenue Ruling 77-402. In the example, C, an individual, creates an irrevocable wholly owned grantor trust. The trustee bought an interest in a partnership. C deducted the distributive share of partnership losses attributable to the partnership interest held by the trust. When the adjusted basis of the partnership interest held by the trust was $1,200, C renounced the grantor trust powers, and the trust then ceased to be a grantor trust. At the time of the renunciation all of the partnership's liabilities are nonrecourse liabilities on which none of the partners have assumed any personal liability. The trust's proportionate share of the partnership liabilities was $11,000. The example concludes when C renounced the grantor trust powers, the trust no longer qualified as a grantor trust, with the result that C was no longer considered to be the owner of the trust and trust property for income tax purposes. Consequently, C was considered to have transferred ownership of the partnership interest to the trust, which was now a separate taxable entity, independent of C. On the transfer, C's share of partnership liabilities ($11,000) was treated as the amount realized by C. C's resulting gain was $9,800 ($11,000 - $1,200).

(6) The taxpayers in *Madorin v. Commissioner*[43] challenged the validity of the foregoing example in the Treasury Regulations, essentially taking the position of the *Rothstein* court (discussed earlier). Bernard Madorin was the grantor of four trusts. The trustee of each of the four trusts had the power to sprinkle income and principal among a class of beneficiaries, and the power to add charitable beneficiaries. The four trusts were, therefore, grantor trusts pursuant to section 674(a) of the Code. The trusts bought partnership interests in a limited partnership, which in turn purchased a partnership interest in Saintly Associates. Bernard recognized losses generated by Saintly Associates. When Saintly Associates began generating

[40] Treas. Reg. § 1.1001-2(a)(1).

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

[42] Treas. Reg. § 1.1001-2(c), Ex. 5

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

income, the trustee renounced his power to add beneficiaries and the trusts ceased to be grantor trusts. The grantor argued that he should be treated as the owner of the trust only to attribute to him items of income, deductions, and credits (the *Rothstein* ruling). The IRS disagreed with the taxpayer and assessed a deficiency. Basing its position on the aforementioned example in the Treasury Regulations, the IRS contended that the grantor was the owner of the partnership interests and when the trusts ceased to be grantor trusts there was a disposition of the trusts' assets (the partnership interests) on which gain would be recognized to the extent that the underlying debt from which the trust was released exceeded the taxpayer's basis in the partnership interests. The Tax Court ruled for the IRS. In coming to that conclusion, the court stated, "Absent a clear and unambiguous legislative directive in this matter, limiting the usage of the word "owner," we will apply the usual, ordinary, and everyday meaning of the word."[44]

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

c. Grantor to Non-Grantor Trust Due to Grantor's Death

(1) If grantor trust status is terminated due to the grantor's death, clearly the grantor-decedent is no longer considered the owner of the trust property for income tax purposes. The IRS has ruled that upon the death of the grantor, the trust springs into existence as a separate taxpayer.[45] Clearly, the trust assets are deemed to be transferred to the new taxpayer, but it's not clear what type of transfer it is, and whether, under some circumstances, it could be considered a taxable event.

(2) Notably, while acknowledging there is no Code section that explicitly addresses the issue, some commentators have asserted categorically that gain or loss is not recognized by a transfer in connection with the death of the owner.[46] They cite *Crane*, *Diedrich v. Commissioner*,[47] section 1.1001-2 of the Treasury Regulations in support of the claim that dispositions of property with debt in excess of basis only results in gain recognition with lifetime transfers, although they do not, collectively or individually, say that. This view is exacerbated by

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[44] *Id.* at 673.

[45] Rev. Rul. 57-51, 1957-1 C.B. 171. *See also* Treas. Reg. 1.671-4(h) ("Following the death of the decedent, the trust or portion of a trust that ceases to be treated as owned by the decedent, by reason of the death of the decedent, may no longer report under this section.").

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

[47] *Diedrich v. Commissioner*, 643 F.2d 499 (8th Cir. 1981) (When a "net gift" is made [i.e., the gift taxes on the transfer, which are the legal obligation of the donor, are instead assumed by the donee as a condition of the gift], the donor will realize gain to the extent the gift tax paid exceeds the donor's adjusted basis in the property).

an IRS ruling that gratuitously stated "death … is generally not treated as an income tax event,"[48] even though the ruling itself was not addressing the income tax consequences of a conversion of a trust's status due to the death of any individual. In furtherance of this notion that a transfer at death is never a recognition event, some commentators have pointed to Revenue Ruling 73-183.[49] In the ruling, a taxpayer purchased stock at $30 per share and later died when the stock had a fair market value of $20 per share. Under section 1014 of the Code, the stock's basis was adjusted to $20 per shares. Notwithstanding the foregoing, the estate of the taxpayer sought guidance on whether a loss is recognized on the taxpayer's final income tax return as a result of the transfer of the stock to the estate. The ruling held that no gain or loss is recognized when stock is transferred from the decedent to the estate, whether the adjusted basis prior to death was less than or in excess of the fair market value on the date of death. These arguments ignore the fact that most transfers at death result in a basis adjustment to fair market value under section 1014 of the Code. If a decedent dies with appreciated property, subject to a nonrecourse debt that is in excess of the property's tax basis prior to death, when the property is "stepped-up" to fair market value, the property no longer has debt in excess of basis.

(3) Estates of decedents who died in 2010 could elect to apply the modified carryover basis regime of now repealed section 1022 of the Code instead of being subject to the estate tax regime that had been reinstated retroactively for that year.[50] Generally, section 1022 of the Code provided that recipients of property from estates that elected out of the estate tax would receive property with a basis equal to the lesser of the adjusted basis of the decedent or the property's fair market value.[51] It provided for certain modifications including the ability to increase the aggregate adjusted basis of estate property up to $1.3 million, [52] with additional increases of up to $3.0 million for property passing to a surviving spouse, outright or to a QTIP trust.[53] The drafters of the Code section clearly understood that if property passes by death but with carryover basis, rather than with a basis adjustment under section 1014 of the Code, gain would be recognized if any property had debt in excess of basis. To that end, they added a specific provision which provides, "In determining whether gain is recognized on the acquisition of property from a decedent by a decedent's estate or any beneficiary other than a tax-exempt beneficiary, and from the decedent's estate by any beneficiary other than a tax-exempt beneficiary, and in determining the adjusted basis of such property, liabilities in excess of basis shall be disregarded."[54] What is particularly telling is, as written, if property with debt in excess of basis had passed from the estate to a tax exempt beneficiary (i.e., charitable organization), gain would have been recognized.

(4) In the mid-1970's, with the 1976 Tax Reform Act, [55] Congress eliminated the step-up in basis and enacted a carryover basis regime under predecessor section

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[48] CCA 200923024 (Dealing with a conversion from non-grantor to grantor trust status, discussed later in these materials).

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

[50] The election out of the estate tax regime is not in the Code. *See* Notice 2011-66, 2011-35 I.R.B. 184, Rev. Proc. 2011-41, 2011-35 I.R.B. 188, and Notice 2011-76, 2011-40 I.R.B. 479.

[51] § 1022(a)(2).

[52] § 1022(b)(2)(B)

[53] § 1022(c)(1).

[54] § 1022(g)(1).

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

1023 of the Code which would have been applied for decedents dying after December 31, 1979. At that time, learned commentators noted that, on the death of the decedent, gain will be recognized upon a transfer of the decedent's property in an amount equal to the difference between basis and liability.[56] In coming to that conclusion they concluded, "transfer effected at death should not be taxed any differently so far as the decedent transferor is concerned than are inter vivos transfers. Any gain or loss recognized on a transfer at death should be reported on the decedent's final return."[57] The carryover basis regime at death was repealed retroactively in 1980, so it never came into effect.[58] One of the reasons for the repeal was likely the debt in excess of basis issue.

(5) Notwithstanding arguments to the contrary,[59] the IRS recently issued Revenue Ruling 2023-2,[60] holding that there is no basis adjustment under section 1014 to the assets of a trust on the death of an individual "who is the owner of the trust under chapter 1 of the Code (chapter 1) if the trust assets are not includible in the owner's gross estate pursuant to chapter 11 of the Code (chapter 11)."[61] In the ruling, the individual taxpayer established an irrevocable trust and funded it with assets in a transfer that was a completed gift for gift tax purposes. The individual retained a power over the trust that caused him to be treated as its owner for income tax purposes under the grantor trust rules. However, the individual did not hold a power over the trust that would result in the inclusion of the trust's assets in his or her gross estate for transfer tax purposes. By the date of the taxpayer's death, the fair market value of the asset had appreciated. At that time, the trust liabilities did not exceed the basis of the trust assets and neither the individual nor the trust held a note on which the other was the obligor. In coming to the conclusion that the basis of the assets after the death of the individual "is the same as the basis of Asset immediately prior to A's death,"[62] the IRS reasoned the basis of the trust assets are not adjusted under section 1014 because the assets were "not acquired or passed from a decedent as defined in § 1014(b)."[63]

(6) Revenue Ruling 2023-2 is in agreement with the conventional view that assets in an IDGT that are not included in the grantor's gross estate will not receive a "step-up" in basis under section 1014. In Chief Counsel Advice 200937028[64] a taxpayer transferred assets into a trust and reserved the power to substitute assets, and the trust assets did not qualify for a basis adjustment under section 1014(b)(1) through (b)(10) of the Code. In the ruling, the Chief Counsel quotes from section 1.1014-1(a) Treasury Regulations: "The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the

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

[57] *Id.* at 569.

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

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

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

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] CCA 200937028.

general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death. . . . Property acquired from the decedent includes, principally . . . property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]" From this the Chief Counsel concludes, "Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9)."[65]

d. Non-Grantor to Grantor Trust

(1) A few private rulings have discussed the income tax consequences of a conversion of a non-grantor trust to a grantor trust.[66] Chief Counsel Advice 200923024 involved trusts created by a parent and three adult children, all of whom held S corporation shares. The S corporation had filed with the SEC to do an initial public offering. Each taxpayer transferred their shares to a partnership, then formed an irrevocable non-grantor trust, funded with $100,000 in cash, and sold his or her partnership interest to his or her respective trust, in exchange for unsecured private annuities. The partnership had a section 754 election in place and, as a result, the partnership increased the basis of the partnership's stock to fair market value (based on the purchase price of the partnership interests) under section 734 of the Code, and then the partnership sold all the shares of the corporation after the IPO for an amount roughly equal to the partnership's basis in the shares (due to the inside basis adjustment). In other words, the partnership (and the trust) recognized little or no gain on the sale of the stock after the IPO. After the sale, the trust advisor removed the corporate trustee of the non-grantor trust and replaced by a person who would be considered a "subordinate party" under section 672(c) of the Code, thereby converting the trusts into grantor trusts under section 674(a) and (c) of the Code. After the trusts became grantor trusts, the taxpayers claimed to "own" all of the partnership interests and reported no gain or other taxable income attributable to any future payments on the private annuity sales.

(2) The IRS agent sought to treat the conversion from non-grantor to grantor trust as a transfer of the underlying assets (partnership interest) to the grantor trusts (the new owner) as a taxable exchange. The non-grantor trusts would recognize little or no gain on the transfer because the outside basis of the partnership interests were equal to their fair market value. On the other hand, the transferee (grantor trusts) would realize taxable income on the receipt of the partnership interests. To that end, the IRS agent cited Revenue Ruling 77-402, section 1.1001-2(c), example 5, of the Treasury Regulations, and *Madorin* (as discussed earlier, all of the foregoing cited authorities stand for the proposition that when converting from a grantor to a non-grantor trust, there is a deemed transfer from the grantor to the trust, and if debt is in excess of basis, there is recognition of gain to the extent of such excess). The IRS Chief Counsel rejected this argument because the authorities only deal with recognition of income to the transferor (not the transferee). In its discussion, the IRS stated the rule set forth in the foregoing authorities is narrow in that it only applies to inter vivos lapses of grantor trust status and then inexplicably and gratuitously adds "not that caused by the death of the owner which is generally not treated as an income tax event."[67] It's the foregoing phrase that consistently gets quoted to stand for the proposition that the IRS does not believe termination of grantor trust caused by the death of the grantor is not a taxable event,

[65] *Id.*

[66] CCA 200923024 and PLR 201730018

[67] *Id.*

despite the fact that the ruling itself does not involve the death of any taxpayer and the conversion in question is the opposite of the termination of grantor trust status. As to the first issue, whether the conversion of a non-grantor trust to a grantor trust is a transfer for income tax purposes of the property held by the non-grantor trusts to the owners of the grantor trusts requiring recognition of gain to the owners, the IRS Chief Counsel ruled that it is "not a transfer for income tax purposes of the property held by the nongrantor trusts to the owner of the grantor trust that requires recognition of gain to the owner."[68]

(3) According to the IRS Chief Counsel, asserting that a conversion like this results in taxable income to the grantor would have an impact on non-abusive situations. The IRS Chief Counsel then provides examples of how a non-grantor trust can become a grantor trust; "examples include the appointment of a related or subordinate trustee to replace an independent trustee as in the present case (§ 674); a borrowing of the trust corpus under § 675(3) (discussed below in ISSUE 2 with regard to the application of Rev. Rul. 85-13); or the payment of the grantor's legal support obligations under § 677(b)." The rule in Revenue Ruling 85-13 provided that the grantor could not engage in a taxable transaction with the grantor trust. Thus, while the IRS Chief Counsel agreed that the transaction at hand was abusive, the IRS should not take the position that it results in taxable income to the grantor.

(4) On the second issue, the IRS agent asserted that the private annuity transaction (the sale of the partnership interests to the trusts) should be treated as an indirect borrowing of the trust assets, causing the trusts to be grantor trusts under section 675(3) pf the Code. As a result, under Revenue Ruling 85-13, the IRS agent argued, the trusts did not get a cost basis upon purchase of the partnership interests and there would be no inside basis adjustment to the stock held by the partnership. The IRS Chief Counsel ruled that this private annuity transaction could not be recast as a loan under section 675(3) of the Code. Despite the positive results for the taxpayer, the memorandum concludes, "Please note that we are not opining on the possible applicability of the step transaction, the economic substance doctrine or other judicial doctrines to the transaction in the present case… Because the case presents an apparent abuse, however, we would like to explore with you further case development that may lead to other arguments to challenge the transaction."[69]

(5) It's unclear what practitioners can take away, if anything, from Chief Counsel Advice 200923024. It could be interpreted to mean that a conversion from non-grantor trust to grantor trust is not a transfer for income tax purposes at all or, at the very least, not a transfer that will result in a recognition event to the grantor. In the one other ruling which, involved the conversion of a non-grantor charitable lead annuity to a grantor trust, the IRS wrote, "Given the lack of authority imposing such consequences, we conclude that the conversion of Trust from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision."[70] In any case, it's hard to see how the Chief Counsel Advice 200923024 can be read to stand for the proposition "the death of the owner … is generally not treated as an income tax event," as is so often quoted by commentators.

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[68] *Id.*

[69] *Id.*

[70] PLR 201730018.

e. Conversions and Unitary Basis

(1) Notwithstanding the lack of clarity, there seems to be consensus that a conversion from a grantor trust to a non-grantor trust is a deemed transfer from the grantor to the non-grantor trust. If the trust and the grantor are partners in a partnership, the unitary basis shared by the grantor and the trust must be allocated between the two of them. How that that basis is allocated is discussed below, but that calculation is critical when debt or partnership liabilities are present. It's doubtful that if the conversion is caused by the death of the grantor, the partnership interest will get a basis adjustment under section 1014.

(2) If the partnership interest collateralizes a debt owed to the grantor (i.e., installment obligation) and such debt exceeds the basis of the partnership interest, then gain will be recognized. Furthermore, if the partnership has nonrecourse liabilities, the trust's resulting share of those liabilities will be treated as an amount realized upon transfer. If conversion to non-grantor trust status is being contemplated, practitioners should determine whether the conversion would cause gain because of insufficient outside basis held by the trust. In such instance, prior to the transfer, as discussed above, the grantor and the grantor trust could make additional contributions of cash or high basis assets to the partnership to increase the unitary basis prior to the transfer and possibly avoid or reduce the amount of gain.

(3) As noted above, the IRS is unclear whether there is a transfer or disregarded transfer when a non-grantor trust converts to a grantor trust. If the non-grantor trust and the grantor are partners in a partnership, the conversion will nonetheless cause the unitary basis rule to apply. As such, the trust's outside basis will be added to the grantor's outside basis. The ramifications of this have been explored above.

C. Allocating Basis to Transfers under the Unitary Basis Rule

1. Generally

a. When a donor makes a gratuitous transfer (or transfer due to a conversion from grantor to non-grantor trust) of a partnership interest to a donee, even if the donee is not deemed to be the donor for income tax purposes (e.g., a grantor trust of the donee), generally no gain or loss is recognized on the transfer.[71] The donee has the donor's basis in the interest received, increased by any gift tax paid.[72] The transferred basis is, however, limited to fair market value of the partnership interest, for purposes of determining a loss.[73]

b. If the donor or grantor transfers only a portion of his or her partnership interest, only a portion of the donor's unitary outside basis is transferred. One would assume that a pro rata portion of the donor's outside basis would also be transferred to the donee. In other words, if a donor owns a partnership interest having an outside basis of $100 and the donor gifts

[71] This assumes that the transfer is not considered a part sale/part gift transfer. Gain, possibly ordinary income under section 751(a) of the Code, but not loss, may be recognized with a part sale/part gift, but only when the sale price exceeds the outside basis of the partnership interest. *See* § 751(a) and Rev. Rul. 60-351, 1960-2 C.B. 169 (gift accelerated gain on an installment obligation). The sale price would be deemed to include any partnership liabilities deemed to have been transferred. *See* § 752(d), Rev. Rul. 77-402, 1977-2 C.B. 222 (grantor trust converting to a taxable trust), and *Madorin v. Commissioner*, 84 T.C. 667 (1985).

[72] § 1015(d).

[73] § 1015(a).

55% to a donee (who is not a grantor trust), then the donee will now own a partnership interest with an outside basis of $55. Surprisingly, that is not be the case.

c. As discussed above, Revenue Ruling 84-53,[74] the IRS ruled in the context of calculating outside basis of a transferred partnership interest, “the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest.”[75] Under this calculation, if the gift of the 55% partnership interest carries a valuation discount (which it should since that reflects fair market value), then the 55% interest would actually transfer less than $55 of basis.

d. For example, assume a donor has a partnership interest that has a fair market value of $200 (the value represents a controlling interest in the partnership but reflects some discounts for lack of marketability) and an outside basis of $100. The donor gifts 45% of his or her partnership interest to a donee. Assume further that 45% transfer carries a valuation discount of 30%. As a result the gift tax value (fair market value) of the transfer is $63 (reflecting a 30% discount on an interest which has a value before the discount of $90). Under the formula of Revenue Ruling 84-53, the transferred interest has a fair market value of $63, and the fair market value of the entire interest is $200, resulting in only 31.5% of the donor’s original basis having been transferred ($63/$200). After the transfer, the donee owns 45% of the partnership interest with an outside basis of $31.50, and the donor retains 55% of the partnership interest but has an outside basis of $68.50.

$$\begin{array}{c}\text{Transferor's}\\ \underline{\text{Adjusted Basis}}\\ \$100\end{array} \times \frac{\begin{array}{c}\text{Fair Market Value (Discounted)}\\ \underline{\text{Transferred Portion}}\\ \$63\end{array}}{\begin{array}{c}\text{Fair Market Value}\\ \underline{\text{Transferor's Entire Portion}}\\ \$200\end{array}} = \begin{array}{c}\text{Transferee's}\\ \underline{\text{Adjusted Basis}}\\ \$31.50\end{array}$$

It should be noted, that had the valuation of the donor’s interests prior to the transfer included the same valuation discount (30%), then the foregoing formula would have resulted in $45 of basis apportioned to the transferred interests (a proportionate percentage). It’s the fact that the value of the transferor’s entire portion has no (or less) valuation discount that causes the “distortion.”

e. Many practitioners are surprised by this result, and some have contended that Revenue Ruling 84-53 is not applicable to gratuitous transfers. [76] It is true that Revenue Ruling 84-53 dealt exclusively with the taxable sale of a partnership interests. The ruling also assumed

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

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

[76] *See* Ellen K. Harrison and Brian M. Blum, *Another View: A Response to Richard Robinson’s “’Don’t Nothing Last Forever’--Unwinding the FLP to the Haunting Melodies of Subchapter K,”* 28 ACTEC J. 313 (2003). In support of their assertion, the authors cite Treasury Regulation section 1.743-1(f) that states, “in the case of the gift of an interest in a partnership, the donor is treated as transferring and the donee is treated as receiving, that portion of the [section 743] basis adjustment attributable to the gifted partnership interest.” *But see* Richard B. Robinson, *Comments on Blum’s and Harrison’s “Another View,”* 28 ACTEC J. 318 (2003).

that there was no discount in value of limited versus general partnership interests.[77] This fact may have been the reason why an "equitable apportionment" of basis was done on the basis of the fair market value of the interest conveyed to the transferor's entire uniform basis. To the extent a discount is involved, transferring a lower amount of basis increases gain. In addition, in the case of gifts, allowing discounts to affect the amount of basis conveyed allows manipulation, as later described in this outline. There are some reasons why the basis apportionment rule may be different for gratuitous transfers, including sales to grantor trusts that can be interpreted as gifts for income tax purposes.

f. On the other hand, sales to grantor trusts are structured to be bona fide sale transactions that are nonetheless ignored for income tax purposes. The Code defines the amount of gain as "the excess of the amount realized therefrom over the adjusted basis."[78] The amount realized is "the sum of any money received plus the fair market value of the property (other than money) received."[79] Since the amount realized is based on fair market value, it makes perfect sense that the basis of the transferred property (the partnership interest) would also be apportioned based on the fair market value of the property. Similarly, estate, gift, and generation-skipping transfer taxes are based on the "value" of the property transferred, sometimes defining the same in terms of "money or money's worth."[80] Value, for these purposes, is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Most would agree that this valuation standard for transfer tax purposes is the same as it would be in determining the amount realized for income tax purposes. Thus, there may be some basis for apportioning tax basis of gifted property by referencing the fair market value (including applicable valuation discounts) of the property.

g. Some commentators argue that Revenue Ruling 84-53 specifically refers to section 1.61-6(a) of the Treasury Regulations which provides, "When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts." They argue that "equitably apportioned" should be interpreted to mean that when a partner transfers 45% of his or her partnership interest, then 45% of the partner's outside basis should "equitably" pass to the transferee.[81] This produces the same result as in Rev. Rul. 84-53 where it was assumed that general and limited partnership interests had the same value regardless of any differences in right to vote and right to liquidate the partnership. A question arises as to the correct result if (i) all of the partnership interests do not have identical voting rights and economic rights to profits, distributions, and partnership capital, and (ii) if there are limitations or restrictions

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[77] Situation 2 in the ruling involved a transfer by A of one half of A's general partnership interest and Situation 3 in the ruling involved a transfer by A of A's limited partner interest. Both transfers involved a sale of 1/3 of A's economic interest in the partnership and both were valued at $10x. Moreover, the ruling misquotes Treas. Reg. § 1.61-6(a) on which it relies. The regulation does not provide that "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market of the entire interest." The regulation says that "when a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts…"

[78] § 1001(a).

[79] § 1001(b).

[80] *See* §§ 2031, 2512 and 2642

[81] *See* Richard B. Robinson, *Comments on Blum's and Harrison's "Another View,"* 28 ACTEC J. 318 (2003) where he correctly points out that "The term 'equitably apportioned' has been consistently interpreted to mean 'divided according to the fair market value of the separate parts.'"

on a partner's ability to immediately receive his or her proportionate share of the fair market value of the partnership's business and assets. What apportionment is equitable where there are differences in partners' rights?

h. To illustrate why fair market value may be an appropriate way of apportioning outside basis, consider a partnership that holds assets and other underlying business interests having a value of $10 million.

(1) Scenario 1: The partnership agreement provides for 2 classes of interests: 50 units of Class A-Voting and 50 units of Class B-Non-Voting. The partnership agreement provides that each unit, whether voting or non-voting, is entitled to a pro rata allocation of all profits and partnership distributions, and the partnership will be liquidated according to capital accounts upon the unanimous vote of all of the Class A holders. Donor owns 50 units of Class A, and 50 units of Class B. Assume, Donor's spouse owns a small interest of Class B, but such interest and its share of partnership capital is ignored for purposes of simplicity (thus, the entity is a partnership for tax purposes, not a disregarded entity). Donor's unitary capital account is $10 million, and the outside basis of the of the Donor's units is $8.0 million. Assume that the Class B units are entitled to a 30% valuation discount. If Donor gifts 50 units of Class B (50% of Donor's units, having a fair market value of $3.5 million), then the transferee will receive $5 million of capital account.

(a) With regard to basis, if one follows Revenue Ruling 84-53, the transferee will succeed to $2.65 of basis (with donor retaining $5.35 million of basis), as follows:

Transferor's Adjusted Basis	x	Fair Market Value (30% Discount) Transferred Portion / Fair Market Value Transferor's Entire Portion	=	Transferee's Adjusted Basis
$8,000,000	x	$3,500,000 / $10,000,000	=	$2,650.000

(b) If one ignores the ruling and apportions basis proportionately (the same way capital account is apportioned), then the transferee would succeed to $4.0 million of basis (50% of the Donor's total basis):

Transferor's Adjusted Basis	x	Percentage Transferred	=	Transferee's Adjusted Basis
$8,000,000	x	50%	=	$4,000,000

(c) If an independent third party purchased the 50 Class B-Non-Voting units from the transferee for cash, the purchaser would not pay $5.0 million (because the units have no voting rights and are unmarketable). It would presumably pay $3.5 million for the Class B units. Under Revenue Ruling 84-53, the seller would recognize $850,000 of gain. On the other hand, if the proportionate rule for basis is used then the seller would actually recognize a $500,000 of loss, which does not seem reasonable since the transferor held appreciated partnership interest before the gift.[82] However, as shown in the example below discussing the possible use of

[82] While not applicable under these facts, if the purchaser had to make a purchase price allocation under section 1060 of the Code (to determine tax liability of the seller and to determine the new basis of the

incomplete gift non-grantor trusts, if the sequence of transfers is changed, the same artificial loss is possible. Similarly, there could be an "artificial" loss if basis was allocated based on relative fair market values and shortly thereafter the partnership was liquidated and distributions were made in accordance with capital accounts. The transferee who had a basis in her interest that was higher than her share of capital accounts might realize a loss, assuming that cash or assets treated as cash were distributed so that the substituted basis rules did not apply to the liquidation.

(2) Scenario 2: The partnership agreement provides for 2 classes of interests: 100 units of Class A Preferred-Voting and 100 units of Class B Common-Non-Voting. The partnership agreement provides the Class A Preferred units have a liquidation preference of $4.0 million and an annual cumulative preferred yield of 12%, and the Class B Common units are entitled to any excess profits or return on the partnership assets after taking into account the economic rights of Class A. Donor owns 100 units of Class A, and 100 units of Class B. Assume, Donor's spouse owns a small interest of Class B, but such interest and its share of partnership capital is ignored for purposes of simplicity (thus, the entity is a partnership for tax purposes, not a disregarded entity). Donor's unitary capital account is $10 million, and the outside basis of the of the Donor's units is $8.0 million. Assume that the Class B units are entitled to a 40% valuation discount. If Donor gifts 100 units of Class B (fair market value of $3.6 million), then the transferee will receive $6.0 million of capital account (because a liquidation of the partnership at the time of the transfer would limit the Class A units to $4.0 million of partnership property). How should the outside basis be "equitably" apportioned to the transferred Class B units? The Class A and Class B do not have identical economic rights to partnership property, profits, and distributions (not to mention Class A has voting rights and Class B does not).

(a) One option is to apportion the basis according to capital accounts, so $4.8 million (60% of the $8 million of outside basis) will pass to the transferee of the Class B units. However, that again presumes that Class A and Class B have identical economic rights under the partnership agreement. They do not. While the holders of Class B may have $6.0 million of capital account, they do not have the right to liquidate the partnership. Further, consider that the 12% cumulative preferential distribution might have been gifted when preferred rates are much lower. Said another way, given how high the Class A preferential rate is, there is a chance that all partnership profits (and perhaps partnership property) will be needed to satisfy the 10% preferred distribution. Based on these facts, apportioning according to capital account balances does not seem reasonable.

(b) The only methodology that takes into account the different economic rights of the Class A and Class B holders and the market conditions at the time of the transfer is to apportion according to fair market values. As mentioned above, the gifted Class B shares are valued at $3.6 million. Prior to the transfer, the Donor had the right to liquidate the partnership, so the Donor's Class A and Class B units are worth $10 million (all of the assets in the partnership) prior to the transfer. It should be noted that this doesn't necessarily mean that the Class A units are worth $6.4 million (a 60% premium over the $4.0 million liquidation preference) but $10 million is the value that a third-party purchaser would pay for all of Donor's units prior to the gift. Pursuant to Revenue Ruling 84-53, the transferred basis allocated to Class B is $2.88 million:

purchased business assets), the Code mandates that the price allocated to an asset may not be more than the fair market value (willing buyer/willing seller) of such asset.

$$\text{Transferor's } \underline{\text{Adjusted Basis}}\ \$8{,}000{,}000 \times \frac{\text{Fair Market Value (Discounted) } \underline{\text{Transferred Portion}}\ \$3{,}600{,}000}{\text{Fair Market Value } \underline{\text{Transferor's Entire Portion}}\ \$10{,}000{,}000} = \text{Transferee's } \underline{\text{Adjusted Basis}}\ \$2{,}880{,}000$$

2. Estate Planning Implications

a. The income and estate planning implications are significant. In the example above, the result is the donor retains a disproportionate amount of the basis, and the donee receives less. If the donee is in a lower income tax bracket or resides in a state (or is a resident non-grantor trust of such state) that has no state income tax and if the donor is in a higher income tax situation, a taxable event like the sale of the partnership interests (or the sale of the assets of the partnership followed by a distribution of the assets) would generally result in less taxes to be paid when compared to having the donor be the sole taxpayer. In addition, if the donee is near death, then holding a lower basis asset provides more potential for a "step-up" in basis.

b. Often, however, the donor is in the senior generation and is wealthier than the donee. Under those circumstances, how can this distortion in basis be used, assuming it would be preferred that the donor retain less basis (for a potential "step-up" in basis) and the donee receive more basis. Consider the following:

(1) As in the first example in the previous section, donor owns a partnership interest that has a fair market value of $200 and an outside basis of $100. Transfers of minority interest in the partnership are entitled to a 30% valuation discount.

(2) The donor transfers a 45% interest to a DING, NING, or other incomplete gift, non-grantor trust.[83] A properly structured incomplete gift, non-grantor trust[84] has the following features:

(a) The trust not a grantor trust (although the grantor is a permissible beneficiary of the trust);

(b) Contributions to the trust by the grantor are not completed gifts for Federal gif tax purposes; and

(c) The assets of the trust are includible in the grantor's gross estate upon the grantor's death, although the corpus is subject to a testamentary special power of appointment held by the grantor.

(3) After the initial transfer to the incomplete gift non-grantor trust, the donor gifts the remainder of his or her partnership interests (55% interest) to an IDGT.

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[83] The same result could be achieved if the donor transfers the interest to the donor's spouse although in that case the basis adjustment would occur, of course, on the spouse's death rather than the death of the grantor. *See* § 1041(b).

[84] *See* Peter Melcher and Steven J. Oshins, *New Private Letter Ruling Breathes Life into Nevada Incomplete Gift Non-Grantor Trusts*, Wealthmanagement.com, the digital resource of REP. and Trusts & Estates (Apr. 16, 2013), and Steven J. Oshins, *NING Trusts Provide Tax and Asset Protection Benefits*, CCH Estate Planning Review - The Journal, Page 150 (Aug. 20, 2013).

c. For basis purposes, based on Revenue Ruling 84-53, the non-grantor trust (the assets of which will be includible in the estate of the donor at death) has a partnership interest with an outside basis of $31.50 (although representing 45% of the donor's interest). The IDGT (the assets of which are not includible in the donor's estate), on the other hand, has a partnership interest with an outside basis of $68.50 (representing 55% of the donor's interest). Thus, a disproportionate amount of basis ends up passing with the partnership interest that is out of the donor's estate, while the partnership interest that remains in the estate is poised to get a disproportionately large "step-up" in basis (particularly, if as discussed above, certain measures are taken to reduce or eliminate the valuation discounts attributable to the partnership interest in the non-grantor trust).

d. In 2021, the IRS placed incomplete gift, non-grantor trusts on its list of areas under study in which rulings will not be issued until the service resolves the issue through the publication of a revenue ruling, revenue procedure, regulation, or otherwise.[85]

D. Section 678, BDOTs, and Unitary Basis

1. Section 678(a) of the Code provides a person (other than the grantor) will be treated as the owner of any portion of a trust if (i) the person has a "power exercisable solely by himself to vest the corpus or the income therefrom in himself,"[86] or (ii) the person "previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof."[87]

2. A trust where a person other than the grantor is conferred "grantor trust" by a "power exercisable solely by himself to vest the corpus or the income therefrom in himself" under section 678(a)(1) of the Code is more commonly referred to as a beneficiary deemed owner trust or BDOT.[88] Common examples of this type of situation include section 2056(b)(5) marital trusts pursuant to which the spouse has a general power of appointment over the entire trust or trusts that permit withdrawal by a beneficiary as an alternative to mandatory termination or distribution when the beneficiary reaches a certain age. The foregoing examples involve the power to vest corpus.

3. An example of a power to vest "the income therefrom" is described in Private Letter Ruling 201633021.[89] The ruling involved Trust 1 and Trust 2 which were non-grantor trusts because the grantor had died. The assets of Trust 1 and Trust 2 are held for the benefit of the same beneficiaries. The governing document of Trust 2 provides that Trust 1 retains the power, solely exercisable by Trust 1, to revest the net income of Trust 2 in Trust 1; provided, however, that such power shall lapse on the last day of such calendar year. Trust 2 further provides that income includes (i) any dividends, interest, fees and other amounts characterized as income under section

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[85] Rev. Proc. 2021-3, 2021-1 I.R.B. 140, Section 5.01(9) and (17).

[86] § 678(a)(1).

[87] § 678(a)(2).

[88] *See* Edwin P. Morrow, *IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)* (2020) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3165592 and a large portion of which was published previously as LISI Estate Planning Newsletter #2587 (Sept 5, 2017).

[89] PLR 201633021.

643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than twelve months, and (iii) any net capital gains realized with respect to assets held longer than twelve months. The ruling provides that the trustee "proposes to transfer funds from Trust 1 to Trust 2."[90] The IRS concluded, "Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2."[91]

4. The ruling unfortunately does not provide any insight on what the income tax consequences would be when Trust 1 "transfers funds" to Trust 2. The language of the ruling implies the Trust 1 will be treated as a beneficiary of Trust 2 but also "as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a)." The language doesn't necessarily (but it could) mean that Trust 1 is the deemed owner entirely of Trust 2 and all of its assets. If Trust 1 is treated as the owner entirely of Trust 2, then theoretically Trust 1 could engage in a sale of the assets of Trust 1 to Trust 2 in exchange for an installment note, and the transaction would be disregarded for income tax purposes under Revenue Ruling 85-13. This would be the result if Trust one could withdraw all the assets of Trust 2 at any time. If, however, Trust 1 is merely an entity that must report the income, capital gain, expenses, and other items used to compute DNI, then such a transaction could, in part, be considered a taxable event. Even if the latter interpretation is correct, if Trust 1 is a non-GST exempt trust and Trust 2 is a GST exempt trust, the tax liability borne by Trust 1 from all of Trust 2's income and capital gain could significantly increase Trust 2's trust assets over time and decrease the assets in Trust 1.

5. In a more recent ruling, Private Letter Ruling 202022002, the trust agreement of a Trust 1 prohibited the distribution of Shares (perhaps of a closely-held company) to the beneficiaries, but allowed for the distribution of the proceeds from the sale of Shares. Trust 1 contributed all of its Shares to LLC, a newly formed entity classified as partnership for Federal tax purposes, in exchange for membership interest in LLC. The same restrictions on the Shares were placed on the membership interests of LLC. Trust 1 then transferred a portion of its LLC interest to a Subtrust for the sole benefit of A. After A reached the age of 40, A exercised a withdrawal right to take all of the Subtrust's assets, except the LLC interests. The Subtrust agreed to sell a portion of its LLC interests to Trust 2 in exchange for cash and a promissory note. Trust 2 is a grantor trust with respect to A. A also has the authority to withdraw the cash and promissory note from Subtrust after the sale. The IRS concluded, "because A has a power exercisable by herself to vest the proceeds of Subtrust's LLC interest in herself and that those proceeds are Subtrust's only asset, A will be treated as the owner of Subtrust under § 678. Consequently, the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A."[92] In this ruling, it is clear that the beneficiary is deemed to be the owner of trust assets for all income tax purposes.

6. In the situation involved in the previous ruling, even if the power holder would not deemed to be the owner of the entire trust, the power holder would be required to "take into account in computing their tax liability those items which would be included in computing the tax

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[90] *Id.*

[91] *Id.*

[92] *Id.*

liability of a current income beneficiary."[93] It seems that if the power holder has that requirement, then for unitary basis purposes, the power holder (beneficiary or other trust) would be considered the same taxpayer. In that case, then, some interesting planning with unitary basis might be possible:

> Example: D, an individual, gifts Asset A, which has an adjusted basis of $0 and a fair market value of $5 million, in trust for the benefit of D's spouse (S) and their descendants (SLAT). At the time of D's subsequent death Asset A has appreciated in value to $10 million. D's Will provides that Asset B, which has a fair market value of $10 million at date of death, will fund a qualified terminable interest property trust (QTIP trust) for the benefit of S. Asset B gets a basis adjustment at death under section 1014 to $10 million.
>
> The governing documents of the SLAT and the QTIP trust are amended (by court order or power of modification vested in an independent trust protector) to provide that the trustee of the QTIP trust has the power to withdraw all of the income under section 643(b) and all of the capital gain of the SLAT. The SLAT which was a grantor trust during the lifetime of D but converted to a non-grantor trust at D's death is now a section 678 deemed-owned trust.
>
> The SLAT, QTIP trust, and 1 other person form a partnership. The third partner has a 1% interest in the partnership, but this 1% interest is ignored for purposes of this example. SLAT contributes Asset A ($0 adjusted basis and $10 million value) and QTIP trust contributes Asset B ($10 million adjusted basis and $10 million fair market value) to the partnership, each receiving a 50% interest in the partnership. Under the unitary basis rule the SLAT and QTIP trust share the $10 million of basis and collectively have a capital account of $20 million.
>
> Sometime later (perhaps 7 years, but as discussed earlier, satisfying the "mixing bowl" time period may not be necessary with deemed owners and deemed-owned trusts), the trustee of the QTIP Trust relinquishes the right to withdraw the income, thereby converting the SLAT from a section 678 deemed-owned trust to a non-grantor trust. As mentioned above, the QTIP trust is deemed to make a transfer of 50% of the partnership to the SLAT. Assuming the transfer carries 50% of the unitary basis, the SLAT, now a separate taxpayer, has a 50% partnership interest with an outside basis of $5 million and capital account of $10 million. If the partnership liquidates, as discussed in II.F.2. of the Subchapter K(ryptonite) Outline, regardless of which assets are distributed to the SLAT and the QTIP trust, each will end up with property having $5 million in basis and fair market value of $10 million. The QTIP trust will eventually get a step-up in basis under section 1014(b)(10) of the Code upon the death of S.

7. In the example above, what if the two trusts involved were a GST exempt trust and non-GST exempt trust and the power held by one trust over the other trust was the power to vest all of the corpus of the other trust. It seems that Revenue Ruling 85-13 would be applicable and the two trusts would be considered the same taxpayer for all federal income tax purposes, not just for purposes of the unitary basis. The two trusts could theoretically then engage in a sale of

[93] PLR 201633021.

assets in exchange for an installment note without any federal income tax consequences. That would not be the case if proposed section 1062 or other similar provision is enacted.

III. BASIS SHIFTING

A. The Basic Elements

1. Boiled down to its purest form, partnership basis shifting requires the following elements: (i) a partnership that owns a low basis asset (or group of assets) and a high basis asset (or group of assets); (ii) the low and high basis asset must have either been purchased by the partnership or if they were contributed, they were contributed more than 7 years ago; and (iii) a partner (or group of partners) who has little or no outside basis in its partnership interest. Assuming all of these elements are present, basis stripping and shifting occurs when the partnership makes a distribution of the high basis asset to the low outside basis partner when the partnership has a section 754 election in place.

> Example: ABC Partnership owns two assets and has a section 754 election in place. Asset A has an inside basis of $0x and a fair market value of $100x. Asset B has an inside basis of $100x and a fair market value of $100x. ABC Partnership has three partners, A, B, and C. The outside basis of C's partnership interest is $0x and a capital account of $100x. ABC Partnership distributes Asset B (the high basis asset) to C in liquidation of C's partnership interest.
>
> As discussed in detail in II.F.2. of the Subchapter K(ryptonite) Outline, Asset B will have its basis reduced to the outside basis of C's partnership interest, which is $0x. This is sometimes referred to as the "basis strip." C owns Asset B outside of the partnership with an outside basis of $0x and a fair market value of $100x. It should be noted that if this was a non-liquidating "current" distribution (e.g., C's capital account was $150x), you would have the same result and C would still be a partner.[94]
>
> Because ABC Partnership has a section 754 election in place, as discussed in II.M.3. of the Subchapter K(ryptonite) Outline, under section 734(b), the adjusted basis of partnership property (the only asset in the ABC Partnership is Asset A) is increased by the amount of basis what was stripped from Asset B upon the distribution to C.[95] As a result, Asset A (as the only asset remaining in the partnership) will have its inside basis increased to $100x. This is sometimes referred to as the "basis shift." The end result is the tax basis that was on Asset B has been "shifted" to Asset A.

2. Although the elements of a basis strip and shift are straightforward, the path to creating an efficient structure to accomplish the shift is quite complex. If the assets used in this technique were contributed to the partnership, the 7-year holding period to avoid triggering gain under the mixing bowl rules is often the most difficult factual hurdle for many clients. It is just

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[94] *See* II.F.1.b. of the Subchapter K(ryptonite) Outline.

[95] The basis increase is "in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution… over the basis of the distributed property to the distributee, as determined under section 732." § 734(b)(1)(B).

simply too long for many clients. In addition, in order to have an efficient basis shift (i.e., tax basis is added to a specific asset in an amount equal to or close to the fair market value of that asset), then the asset (or group of assets) receiving the basis must be the only asset left in the partnership. Otherwise, the basis increase created from the strip will be allocated across a number of partnership assets, none of which will likely get a full basis increase to fair market value. Furthermore, as noted in II.M.4. of the Subchapter K(ryptonite) Outline, both assets in the basis strip and shift must be of the same class (i.e, both capital assets or both ordinary income assets). Practitioners should also remember that if the partnership has "hot" (ordinary income) assets, a disproportionate distribution of a capital asset (or vice versa) may trigger gain under section 751.[96] Thus, it is recommended that partnerships only hold one class of property (i.e., only capital assets). This is why, as noted in II.N.3. of the Subchapter K(ryptonite) Outline, partnership divisions are a critical step in basis shifting, in particular, vertical slice divisions. A vertical slice division is a tax free method of segregating classes of assets and, more importantly, isolating the low and high basis assets that will be the subject of the basis strip and shift into its own partnership. Lastly, the partner (or partners) receiving the distributed asset must have a low outside basis. To that end, the unitary basis rule will generally increase the basis of the recipient partner, so turning off grantor trust status may be one of the preliminary steps toward the goal of the recipient partner having a low outside basis. As one can see, creating an efficient basis shift environment is much more difficult to create, than the actual mechanics of it. However, it is possible, by way of example:

a. Practitioners should consider setting up a partnership that is funded with all manner of assets that might be used in this type of planning (high and low basis assets, depreciable and non-depreciable assets, closely held company interests, cash, etc.). The more assets the taxpayers contribute, the more options will be available in the future. The only type of asset planners should consider avoiding is marketable securities.[97] This is because, generally, a distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property) when assets other than marketable securities are held by the partnership.[98] Thus, regardless of the basis in the marketable securities, a distribution may cause the distributee partner to recognize gain because of insufficient outside basis. 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. 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.

b. 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, as discussed in II.M.2 of the Subchapter K(ryptonite) Outline. Once the seven year period has expired, then the assets of the partnership (that is hopefully free of a section 754 election) are ripe for proactive tax basis management. 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 then proceed to isolate the appropriate assets in tax free "vertical slice" division. The assets to be carved out of the larger partnership into a smaller partnership would be those assets selected to receive the basis and those that would have their basis reduced upon distribution. Careful consideration should be given to reducing the outside basis of the distributee partner through disproportionate distributions of cash,

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[96] *See* II.F.3. of the Subchapter K(ryptonite) Outline.

[97] *See* II.F.7. of the Subchapter K(ryptonite) Outline.

[98] § 731(c). *See also* II.F.7. of the Subchapter K(ryptonite) Outline.

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), [99] or as noted, turning off grantor trust status.

c. Upon distribution of the higher basis assets to the distributee partner, the inside basis adjustment would be applied across all of the remaining assets in the partnership, but only those assets that have been spun off the larger partnership are in this partnership. Thus, allowing 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). A section 754 election is required to effectuate the inside basis shift under section 734, but the election would only apply to the smaller, isolated partnership. As such, the record keeping requirements are kept to a minimum and are totally eliminated when and if the smaller partnership is dissolved and liquidated. 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. By keeping the larger partnership free of a section 754 election, it allows practitioners to selectively choose when and over what assets it would apply to in the future.

B. Basis Shifts to Diversify a Concentrated Stock Position

1. Introduction

a. Investors with a low-basis "single stock" or concentrated stock position often look for strategies that allow them to diversify (or hedge) the concentrated position and that either defer the recognition of or eliminate the recognition of capital gain. For example, prepaid variable forward strategies allow investors to hedge the underlying stock position and provide funds to invest in a diversified portfolio, and exchange funds allow investors to contribute their concentrated stock positions to a partnership and after at least seven years, leave the partnership with a "diversified" portfolio consisting of the stocks contributed by the other partners. The prepaid variable forward strategy only defers the recognition of capital gain, and although the exchange fund allows for a tax free method of getting a portfolio of stocks different from the concentrated position, there is no guarantee that the portfolio of stocks received is of high quality or appropriately diversified. In addition, all of these strategies come at a cost that might include investment management fees, relinquishment of upside appreciation, or less than 100% of value invested in a diversified portfolio. Carefully utilizing the basis rules in a family limited partnership may be a superior alternative to the foregoing.

b. All of the strategies discussed in this section assume that (i) the partnership entity is an "investment partnership" under section 731(c)(3)(C) of the Code or if not, the partnership only holds marketable securities,[100] and (ii) all of the assets in the partnership have been contributed more than seven years ago or have been purchased by the partnership. As such, distributions of marketable securities are not treated as distributions of cash under section 731(c) of the Code, and the "mixing bowl" rules do not apply. Further, assume the disguised sale rules do not apply, and the relevant anti-abuse rules would not apply to recharacterize the partnership transactions.

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[99] *See* Treas. Reg. § 1.752-2(b).

[100] *See* § 1.731-2(b)(2) and the discussion in II.F.7. of the Subchapter K(ryptonite) Outline.

2. Shifting Basis from a Diversified Position to a Concentrated Position

a. Assume a FLP owns $100 million of assets comprised of: (i) $50 million of Stock A, a publicly-traded security, with zero basis, and (ii) $50 million of a diversified portfolio of marketable securities (or shares in a diversified stock exchange-traded fund, ETF) with $50 million of basis. The FLP is owned equally by family members of the first generation (G1 Partners) and of the second generation (G2 Partners), each generation holding a 50% interest in the FLP. To simplify the example, the two generational groups of partners will be referred to collectively (and separately) as the G1 and G2 Partners. Each of the G1 and G2 Partners has $25 million of outside basis, and each of the partner groups have a capital account balance of $50 million. The FLP was formed more than seven years ago when the G1 and G2 Partners each contributed an equal amount of Stock A,[101] and recently one-half of the Stock A position was sold for cash and a diversified portfolio of marketable securities. The G1 and G2 Partners each recognized $25 million of capital gain. As a result, the adjusted tax bases and capital accounts are:

Partnership Holding Stock A & Diversified Portfolio				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$0	$50,000,000	
	Diversified Portfolio	$50,000,000	$50,000,000	
	TOTAL	**$50,000,000**	**$100,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
50%	G1 Partners	$25,000,000	$50,000,000	
50%	G2 Partners	$25,000,000	$50,000,000	
	TOTAL	**$50,000,000**	**$100,000,000**	

b. The FLP wishes to sell the remaining position in Stock A for cash in an effort to diversify the concentrated position in Stock A. If the FLP sells the Stock A position, the results are straightforward. The FLP recognizes $50 million of capital gain, and G1 and G2 are each allocated 50% of the gain ($25 million each), as follows:

Partnership Sells Stock A for Cash				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Cash	$50,000,000	$50,000,000	$50,000,000
	Diversified Portfolio	$50,000,000	$50,000,000	
	TOTAL	**$100,000,000**	**$100,000,000**	**$50,000,000**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
50%	G1 Partners	$50,000,000	$50,000,000	$25,000,000
50%	G2 Partners	$50,000,000	$50,000,000	$25,000,000
	TOTAL	**$100,000,000**	**$100,000,000**	**$50,000,000**

[101] The contribution would have been a non-taxable event under section 721(a) of the Code even though the FLP would have constituted an investment company under sections 721(b) and 351(e) of the Code. The contributions of Stock A did not result in any diversification. Treas. Reg. §§ 1.351-1(c)(1)(i) and 1.351(1)(c)(5).

c. Instead of selling Stock A, assume the FLP makes a 754 election or has one in effect at such time, and the FLP could makes an in-kind distribution of the diversified portfolio to the G1 Partners in a liquidating distribution (G1's capital account balance and the diversified portfolio each have a value of $50 million). Under section 732(b) of the Code, the diversified portfolio in the hands of the G1 partners has a basis of $25 million (having been reduced from $50 million). Under section 734(b) of the Code, the partnership's assets (Stock A) are increased by "the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution… over the basis of the distributed property to the distributee."[102] In other words, the FLP basis in Stock A is increased by $25 million. The resulting adjusted tax bases, capital accounts of the remaining G2 Partners, and assets held by the former G1 Partners are:

Partnership Distributes Diversified Portfolio to G1 Partners (754 Election/734(b) Adjustment)				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$25,000,000	$50,000,000	
	TOTAL	**$25,000,000**	**$50,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
100%	G2 Partners	$25,000,000	$50,000,000	
	TOTAL	**$25,000,000**	**$50,000,000**	
	Diversified Portfolio	*Tax Basis*	*Fair Market Value*	
	Former G1 Partners	$25,000,000	$50,000,000	

d. If the FLP subsequently sells the Stock A position for its fair market value and then purchases a diversified portfolio, then only $25 million of gain will be recognized. The overall result is that all of Stock A will have been diversified, but only $25 million (rather than $50 million) was recognized, as illustrated below:

Partnership Sells Stock A and Reinvests in a New Diversified Portfolio				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	New Diversified Portfolio	$50,000,000	$50,000,000	$25,000,000
	TOTAL	**$50,000,000**	**$50,000,000**	**$25,000,000**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
100%	G2 Partners	$50,000,000	$50,000,000	$25,000,000
	TOTAL	**$50,000,000**	**$50,000,000**	**$25,000,000**
	Diversified Portfolio	*Tax Basis*	*Fair Market Value*	
	Former G1 Partners	$25,000,000	$50,000,000	

[102] § 734(b)(1)(B).

Of course, the G1 Partners continue to have an unrealized $25 million capital gain, but that gain can be deferred indefinitely and possibly eliminated with a "step-up" in basis upon the death of the G2 Partners.

3. Using Debt to Exchange a Concentrated Position for a Diversified One

a. Assume a FLP that has one asset, $100 million of a publicly traded security, Stock A, that has zero basis. The FLP is owned by family members, 10% by first generation (G1 Partners) and 90% by the younger generations (G2 Partners). The two generational groups of partners will be referred to collectively (and separately) as the G1 and G2 Partners. The adjusted tax bases and capital accounts are:

PARTNERSHIP HOLDING STOCK A				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$0	$100,000,000	
	Cash	$0	$0	
	Debt		$0	
	TOTAL	**$0**	**$100,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
10.0%	G1 Partners	$0	$10,000,000	
90.0%	G2 Partners	$0	$90,000,000	
	TOTAL	**$0**	**$100,000,000**	

b. The family is considering winding up the affairs of the FLP and liquidating the partnership. They are also looking for ways to tax efficiently diversify the concentrated position in Stock A. Instead of selling Stock A and recognizing $100 million of gain, the FLP borrows $90 million from a third party lender. The third party lender, as a condition for the loan, requires a pledge of the $100 million of the Stock A held by the partnership, and (given the size of the loan against a concentrated stock position) it also requires the G1 Partners (who have significantly more net worth than the G2 Partners) to personally guarantee the loan and post additional personal assets as collateral for the loan, in case the FLP is unable to pay any portion of the loan. The G1 Partners agree with the G2 Partners to be solely responsible for the repayment of any partnership liabilities with respect to this loan and give up any right of reimbursement from the G2 Partners. Assume, under the current and proposed Treasury Regulations, the partnership liabilities under section 752 of the Code are properly allocated to the G1 Partners because they bear the economic risk of loss. When the $90 million loan is procured, the adjusted tax bases, capital accounts, and books of the partnership are:

PARTNERSHIP BORROWS $90 MILLION, G1 PARTNERS BEAR ECONOMIC RISK OF LOSS				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$0	$100,000,000	
	Cash	$90,000,000	$90,000,000	
	Debt		($90,000,000)	
	TOTAL	**$90,000,000**	**$100,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
10.0%	G1 Partners	$90,000,000	$10,000,000	
90.0%	G2 Partners	$0	$90,000,000	
	TOTAL	**$90,000,000**	**$100,000,000**	

c. The FLP then purchases a diversified marketable securities portfolio in the form of shares in an exchange traded fund (ETF). After the purchase, the partnerships books are:

PARTNERSHIP BUYS ETF WITH LOAN PROCEEDS				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$0	$100,000,000	
	ETF	$90,000,000	$90,000,000	
	Debt		($90,000,000)	
	TOTAL	**$90,000,000**	**$100,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
10.0%	G1 Partners	$90,000,000	$10,000,000	
90.0%	G2 Partners	$0	$90,000,000	
	TOTAL	**$90,000,000**	**$100,000,000**	

d. Later, assuming the FLP makes a 754 election or has one in effect, the FLP distributes the ETF to the G2 Partners in liquidation of their interest in the FLP. The capital account balance of the G2 Partners and the fair market value of the ETF are $90 million. Under section 732(b) of the Code, the ETF in the hands of the G2 partners has a basis of zero.[103] Under section 734(b) of the Code, the partnership's assets (Stock A) are increased by the $90 million of excess basis that was stripped from the ETF. The results are:

[103] In this example, the G1 partners bear the economic risk of loss and the partnership liability is recourse to the G1 partners. As a result, the outside bases of the G1 partners are increased by the total liability under section 752(a) of the Code. If, in contrast, the partnership liabilities were considered nonrecourse liabilities and all of the partners had their outside bases increased by a proportionate amount of the liability, you would get the same result (the ETF in the hands of the G2 partners has a basis of zero) because the interests of the partners are fully liquidated. As a result, when the G2 partners exit the partnership and they are no longer share any of the partnership liabilities, there is a deemed distribution of money under section 752(b) of the Code, reducing their outside bases to zero, which is then followed by a distribution of the ETF with an inside basis of $90 million.

§ 754 ELECTION AND INSIDE BASIS ADJUSTMENT UNDER § 734				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$90,000,000	$100,000,000	
	Cash	$0	$0	
	Debt		($90,000,000)	
	TOTAL	**$90,000,000**	**$10,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
100%	G1 Partners	$90,000,000	$10,000,000	
	TOTAL	**$90,000,000**	**$10,000,000**	
	ETF	*Adjusted Basis*	*Fair Market Value*	
	Former G2 Partners	$0	$90,000,000	

e. Assuming no changes in value and ignoring interest and other costs, when the FLP then sells $90 million of Stock A (90% of the partnership's holdings) to repay the loan, the FLP will recognize $9 million of gain. The gain will be reflected in the outside basis of the G1 Partners, as follows:

PARTNERSHIP SELLS ENOUGH STOCK A TO REPAY LOAN				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	*Gain*
	Stock A	$0	$10,000,000	
	Cash	$90,000,000	$90,000,000	$9,000,000
	Debt		($90,000,000)	
	TOTAL	**$90,000,000**	**$10,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	*Gain*
100%	G1 Partners	$99,000,000	$10,000,000	$9,000,000
	TOTAL	**$99,000,000**	**$10,000,000**	

f. The subsequent repayment of the loan to the third party lender will decrease the outside basis of the G1 Partners under section 752(b) of the Code:

PARTNERSHIP PAYS OFF THIRD PARTY LOAN				
	Partnership	*Inside Basis*	*§ 704(b) Book Value*	
	Stock A	$9,000,000	$10,000,000	
	Cash	$0	$0	
	Debt		$0	
	TOTAL	**$9,000,000**	**$10,000,000**	
(%)	*Partners*	*Outside Basis*	*Book Capital Account*	
100%	G1 Partners	$9,000,000	$10,000,000	
	TOTAL	**$9,000,000**	**$10,000,000**	

g. If the FLP subsequently liquidates and winds up its affairs, assuming no changes in values, the end result is exactly the same as it would have been if G2 had contributed its allocable share of Stock A to a third party exchange fund and then liquidated its share of the fund seven years later. In this strategy, however, there is no need to wait seven years (the "mixing

bowl" period was tolled in the FLP), the diversified portfolio is chosen by the family (rather than what may be held by the exchange fund including non-equity assets [e.g., real estate investments] that are typically held by exchange funds to avoid investment company status), and there is minimal gain:

LIQUIDATION OF PARTNERSHIP AND END RESULT			
Former Partner	*Adjusted Basis*	*Fair Market Value*	*Gain*
G1 (STOCK A)	$9,000,000	$10,000,000	$9,000,000
G2 (ETF)	$0	$90,000,000	$0

C. Basis Shifts with Grantors and Grantor Trusts

1. Generally

a. When reduced down to its simplest form, basis shifting transactions involve a partnership holding a low and a high basis asset, a partner having a low outside basis in his or her partnership interest, and a distribution of the high basis asset to the low outside basis partner. Often, however, a partnership may not have any assets with sufficient basis in order to effectuate the basis shift.

b. In the previous example dealing with marketable securities, the partnership used leverage to purchase an asset, thereby acquiring a high basis asset. If, however, partnership debt is not an option, a contribution of a high basis asset to the partnership should be considered. The difficulty with using contributed property in this type of planning is that the distribution of the high basis asset may trigger a taxable gain under the disguised sale and mixing bowl transaction rules.

c. Contributions by a grantor to a partnership that has a grantor trust (IDGT) as a partner may be a way to reduce the risk of triggering gain because of the unitary basis rules. As mentioned earlier in these materials, the unitary basis rules require that a grantor and an IDGT will share outside basis (and capital account), and as a result, contributions of high basis assets by one or the other will result in a proportional increase in the outside basis that is shared by both partners.

2. Basis Shift Example

a. A limited partnership (LP) has an S corporation as general partner, with 100% of the limited partnership interests owned by an IDGT. Assume that the S corporation owns a sufficient interest in the LP to be recognized as partner for tax and state law purposes (e.g., 1%), but for purposes of this illustration, its interest in the partnership will be ignored. The LP owns Asset A with an inside basis of zero and a fair market value of $100x. The IDGT owns 100% of the limited partnership interests which have an outside basis of zero and a capital account of $100x. For tax reasons, the partnership would like Asset A to have tax basis.

b. Grantor contributes Asset B, which has an adjusted basis of $100x and a fair market value of $100x, to the LP in exchange for 50% of the limited partnership interests. After the contribution, grantor and IDGT are equal partners, each owning an equal share of all of the limited partnership interests. Due to unitary basis and capital account rules, grantor and IDGT share an outside basis of $100x and a capital account of $200x. LP owns Asset A ($0 basis/$100x in value) and Asset B ($100x basis/$100x in value).

c. So long as grantor and IDGT are considered the same taxpayer, they will continue to share an outside basis of $100x such that if Asset B (high basis asset) is distributed to either of them, it's unlikely that a basis reduction would occur because the basis that is shared by both of them is equal to the tax basis of Asset B. However, what if grantor trust status is relinquished with respect to the IDGT?

d. When grantor trust status is lost, the grantor is deemed to make a transfer of the partnership interest held by the trust, which is now a separate taxpayer, as a non-grantor trust. In this example, grantor is deemed to make a transfer of 50% of the limited partnership interests to the trust, which requires an allocation of outside basis and capital account to the transfer. Prior to the transfer, the unitary basis of all of the limited partnership interests was $100x and the capital account was $200x. 50% of the capital account or $100x will go to the trust upon the deemed transfer. As discussed above, according to Revenue Ruling 84-53, the amount of basis that is allocated to the transfer depends on the relative fair market values of the transferred interest and the entire interest prior to the transfer.

e. Let's assume in "Version 1" of this example, the fair market value of 100% of the limited partnership is equal to the capital account balance of $200x (liquidation value) because the sole shareholder of the S corporation is the grantor who is the transferor in this deemed transfer. The grantor has the power to compel liquidation of the LP. If the deemed transfer of the 50% limited partnership interest to the trust carries a 30% valuation discount, then $35x of basis will pass to the trust ($65x will remain with the grantor), as follows:

$$\underset{\$100x}{\text{Transferor's Adjusted Basis}} \times \frac{\text{Fair Market Value (Discounted) Transferred Portion } \$70x}{\text{Fair Market Value Transferor's Entire Portion } \$200x} = \underset{\$35x}{\text{Transferee's Adjusted Basis}}$$

f. The resulting partnership books after the deemed transfer are as follows:

LP: Version 1 (After Deemed Transfer)			
	Partnership	*Inside Basis*	*§ 704(b) Book Value*
	Asset A	$0	$100
	Asset B	$100	$100
	TOTAL	**$100**	**$200**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*
50%	Grantor	$65	$100
50%	Trust (Former IDGT)	$35	$100
	TOTAL	**$100**	**$200**

g. Assuming a section 754 election is in place, if Asset B is distributed to the trust in liquidation of its interest in the LP, the resulting partnership books and position of the trust are as follows:

LP: Version 1 (After Liquidating Distribution to Trust)			
	Partnership	*Inside Basis*	*§ 704(b) Book Value*
	Asset A	$65	$100
	TOTAL	**$65**	**$100**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*
100%	Grantor	$65	$100
	TOTAL	**$65**	**$100**
	Asset B	*Tax Basis*	*Fair Market Value*
	Trust (Former IDGT)	$35	$100

h. Version 1 of this example results in a shift of $65x of basis to Asset A with $35x remaining with Asset B now owned by the trust outside of the partnership.

i. In "Version 2" of this example, everything is the same except the fair market value of 100% of the limited partnership is not equal to a liquidation value of $200x. Rather, the fair market value of the limited partnership interests held by the grantor have a 30% valuation discount associated with them (because in Version 2, perhaps, the grantor is not have control of the S corporation general partner of LP). The value of the grantor's interests prior to the deemed transfer is $140x. If the deemed transfer of the 50% limited partnership interest to the trust carries a 30% valuation discount, then $50x of basis will pass to the trust ($50x will remain with the grantor), as follows:

$$\underset{\$100x}{\text{Transferor's Adjusted Basis}} \times \frac{\text{Fair Market Value (Discounted) Transferred Portion } \$70x}{\text{Fair Market Value Transferor's Entire Portion } \$140x} = \underset{\$50x}{\text{Transferee's Adjusted Basis}}$$

j. The resulting partnership books after the deemed transfer are as follows:

LP: Version 2 (After Deemed Transfer)			
	Partnership	*Inside Basis*	*§ 704(b) Book Value*
	Asset A	$0	$100
	Asset B	$100	$100
	TOTAL	**$100**	**$200**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*
50%	Grantor	$50	$100
50%	Trust (Former IDGT)	$50	$100
	TOTAL	**$100**	**$200**

k. Assuming a section 754 election is in place, if Asset B is distributed to the trust in liquidation of its interest in the LP, the resulting partnership books and position of the trust are as follows:

LP: Version 2 (After Liquidating Distribution to Trust)			
	Partnership	*Inside Basis*	*§ 704(b) Book Value*
	Asset A	$50	$100
	TOTAL	**$50**	**$100**
(%)	*Partners*	*Outside Basis*	*Book Capital Account*
100%	Grantor	$50	$100
	TOTAL	**$50**	**$100**
	Asset B	*Tax Basis*	*Fair Market Value*
	Trust (Former IDGT)	$50	$100

l. Version 2 of this example results in a shift of $50x of basis to Asset A with $50x remaining with Asset B now owned by the trust outside of the partnership, which may seem less effective, but as discussed below, it may solve a taxable gain issue under the mixing bowls transaction rules.

3. Possible Income Tax Implications

a. Generally

(1) As mentioned above, whenever property is contributed to a partnership and, within a certain period of time, partnership property is distributed to a partner, there is the potential to trigger gain under the disguised sale and mixing bowl transaction rules.

(2) In the example above, the LP held Asset A that had an inside basis of zero and a fair market value of $100x. Assume that the LP was formed by contribution of Asset A to LP in exchange for 100% of the limited partnership interests, and assume that there has been no change in the value of Asset A since contribution.

(3) The tax implication of Version 1 and Version 2 in the example above depend, in large part, on how long the asset has been held by the partnership.

b. Disguised Sale

(1) As discussed in II.F.5. of the Subchapter (K)ryptonite Outline, if a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash generally 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. Thus, assuming no facts or circumstances that would properly characterize the transaction as a sale, the operating holding period for Asset A is two years.

(2) If Asset A has been held by the partnership for less than two years at the time of the distribution of Asset B, then the disguised sale will be presumed to have occurred. Interestingly, it likely would have not have made a difference whether the grantor originally contributed Asset A to LP (and subsequently transferred 100% of the limited partnership interests to the IDGT) or if the IDGT originally contributed Asset A to the LP because they would be considered the same taxpayer under the grantor trust rules. As such, both the grantor trust and the IDGT would be considered the contributing partner. Also note that the Code provides that the elements of a disguised sale can occur if (i) there is a contribution to the partnership by a partner, (ii) there is a "transfer of money or other property by the partnership to such partner (or another partner),"[104] and (iii) the transfers "when viewed together, are properly characterized as a sale or exchange of property."[105]

(3) In either Version 1 or Version 2 in the example above, if Asset A has been held by the partnership for two years or less, a disguised sale is deemed to occur, resulting in a deemed sale of Asset A for $100x and resulting in $100x of gain. The basis that could have been shifted to Asset A in the basis shifts above would not reduce the amount of gain because a disguised sale is calculated as of the original date of contribution.

c. Mixing Bowl Transaction

(1) As discussed above, the mixing bowls transaction provisions of sections 704(c)(1)(B) and 737 of the Code have a seven year time limit. Both operative sections of the mixing bowl transaction rules are operative in this example. If Asset A has been in the partnership for more than two years but seven years or less at the time of the distribution of Asset B, then the mixing bowl transaction rules will be triggered and a taxable event will be deemed to have occurred, but the gain differs in Version 1 and Version 2.

(2) Section 704(c)(1)(B) provides if contributed property is distributed within seven years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution. [106] Further, with respect transfers of partnership interests, the Treasury Regulations provide, for section 704(c) purposes, "If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built- in gain or loss proportionate to the interest transferred must be allocated to the transferee partner."[107] Specifically to contributed property distributions to another partner, the Treasury Regulations provide, "The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner."[108]

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[104] § 707(a)(2)(B)(ii).

[105] § 707(a)(2)(B)(iii).

[106] § 704(c)(1)(B).

[107] Treas. Reg. § 1.704-3(a)(7).

[108] Treas. Reg. § 1.704-4(d)(2).

(3) Section 737 provides if a partner contributes appreciated property to the partnership and, within seven years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally will be required to recognize gain upon the receipt of such other property.[109] Thus, section 737 only applies to property received that was not otherwise contributed by such partner.

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

(a) The excess (if any) of the fair market value (other than money) received in the distribution over the adjusted basis of such partner's outside basis immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution (the "excess distribution");[110] or

(b) The "net precontribution gain,"[111] which is the net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if, at the time of the distribution, all section 704(c) property contributed by the distributee partner within 7 years of the distribution that is still held by the partnership were distributed to another partner.[112]

(5) As discussed in more detail II.F.4. of the Subchapter (K)ryptonite Outline, although there is some debate as to whether a transferee under section 737 is treated as a contributing partner, the consensus view is that a transferee steps into the shoes of the transferor as the contributing partner.

(6) In the example above, grantor and IDGT are essentially both contributors of the appreciated Asset A (section 704(c) property) and of the high basis asset, Asset B (as far as the unitary basis rules are concerned). When the IDGT converts to a non-grantor trust, there is a deemed transfer of 50% of the limited partnership interests to the trust. Prior to the deemed transfer, grantor (as the taxpayer) was the contributor of both assets. After the transfer, the trust, as transferee (now a separate taxpayer), steps into the grantor's shoes but only with respect to ½ of each of Asset A and Asset B. It is similar to how they would be treated under the mixing bowl transaction rules if grantor and the trust had formed LP by each contributing an undivided ½ interest in Asset A and Asset B in exchange for 50% each of the limited partnership interests.

(7) When Asset B is distributed to the trust in both versions of the example above, one-half of Asset B is being returned to the trust. That portion that is being "returned" to the trust does not trigger section 704(c)(1)(B) because that one-half portion of Asset B was deemed to have been contributed by the trust (transferee steps into the shoes of the grantor as contributor). Section 737 applies to other property distributed to the contributing partner. The trust is deemed to be the contributor of one-half of Asset A. In the example, the distribution of the

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[109] §§ 704(c)(1)(B) and 737.

[110] § 737(a)(1).

[111] § 737(a)(2).

[112] § 737(b). Other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. *See* Treas. Reg. § 1.737-1(c)(1). Further, any losses inherent in section 704(c) property contributed by the distributee partner within the preceding 7-year period are netted against gains in determining net precontribution gain. *See* Treas. Reg. § 1.737-1(e), Ex. 4(iv).

other one-half of Asset B (the one-half that was contributed by the grantor and retained by the grantor because only 50% is transferred to the trust) to the trust will trigger section 737.

(8) The amount of gain under section 737 is a lesser of the excess distribution, and the net precontribution gain.

(a) In Version 1, the outside basis of the trust is $35x, and the inside basis of Asset A is $65 after the distribution but zero at the time of the distribution. The excess distribution is $15x (fair market value of the *other* one-half of Asset B [$50x] over the trust's outside basis [$35x]). The net precontribution gain under section 704(c)(1)(B) is $50x. It is limited to 50x because the trust is the deemed contributor of one-half of Asset A. The *other* one-half of Asset A has $50x of gain. In all, because section 737 uses a lesser of rule, Version 1 would result in $15x of gain.

(b) In Version 2, the outside basis of the trust is $50x, and the inside basis of Asset A is $50 after the distribution but zero at the time of the distribution. The excess distribution is zero (fair market value of the *other* one-half of Asset B [$50x] over the trust's outside basis [$50x]). The net precontribution gain under section 704(c)(1)(B) is $50x, as explained above. Version 2 would result in *no gain*.

(9) As illustrated, in this type of basis shift, when the appreciated contributed asset has been in the partnership for more than two years but for seven years or less, the amount of gain that might result is a function of how much outside basis is allocated to the distributee partner, the trust. That, in turn, is often a function of the valuation discounts that might be applicable to the partnership interests at the time of the deemed transfer when the grantor trust converts to a non-grantor trust.

(10) If, in the example above, Asset A has been held by LP for more than seven years, the mixing bowl transactions rules would not be applicable, and both Version 1 and Version 2 would result in *no gain*.

IV. SECTION 2036: INSIDE/OUTSIDE BASIS CONUNDRUM

A. Generally

1. When property is included under section 2036(a) of the Code, the amount of inclusion is not the value of the specific interest subject to the to the retained interest[113] or the control of the transferor.[114] Rather, the amount of inclusion is the fair market value of the property that was subject to the retained interest or power that caused inclusion under section 2036(a).[115] In the context of a partnership, this means the assets in the partnership are subject to estate tax inclusion, and under section 1014(b)(9), it appears that the inside basis of the partnership assets are adjusted to fair market value.[116]

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[113] If inclusion is due to section 2036(a)(1) of the Code.

[114] If inclusion is due to section 2036(a)(2) of the Code.

[115] *See* 2036(a).

[116] "In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in

2. If partial consideration was received at the time of the original transfer, the amount of inclusion under section 2036(a) is reduced by section 2043(a) which provides, in pertinent part, if any transfer or power described in section 2036 "is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent."[117]

3. If the decedent owns an interest in the partnership on the date of death, the outside basis of the partnership interests will get a basis adjustment to fair market value, but such value may include valuation discounts. The result is that the inside basis of the assets will likely be higher than the outside basis. This disparity will eventually cause the partners to either lose basis (or recognize gain) because, as explained in II.F.1. and II.F.2. of the Subchapter K(ryptonite) Outline, the basis of distributed property, whether due to a current or liquidating distribution of property, will be limited to the outside basis of the distributee partner (which in this case will be lower than the inside basis of the partnership property). There does not seem to be any mechanism in subchapter K to adjust outside basis when there is this type of inside basis discrepancy.

4. If the partnership has a section 754 election in place, then under section 743(b)(2), the adjusted basis of the partnership property will be reduced by the "excess of the transferee partner's proportion share of the adjusted basis of the partnership property over the basis of his interest in the partnership."[118] This will cause a reduction of inside basis, but not change the amount of inclusion. As discussed in II.M.2. of the Subchapter K(ryptonite) Outline, the reduction in inside basis only applies to the transferee partner, and as a result the transferee partner will be allocated more gain than the other partners if partnership property is sold for a gain.

5. These inside and outside basis discrepancies become even more extreme when there is estate tax inclusion under section 2036, but the partnership interests are not included in the estate. Quite often clients gift or sell (i.e., to a grantor trust in exchange for an installment note) partnership interests during their lifetimes. As discussed herein, these assets will not get a basis adjustment under section 1014. This issue is discussed in more detail below.

B. Amount of Inclusion: *Powell* and *Moore*

1. The *Powell* Opinion

a. In *Estate of Powell v. Commissioner*,[119] , the decedent's son, acting under a power of attorney for the benefit of the decedent, contributed $10 million of cash and securities to a family limited partnership (FLP) in return for 99% limited partnership interest. The decedent's two sons contributed unsecured promissory notes to the FLP in exchange for a 1% general partnership interest. The son, acting under the power of attorney, contributed the 99% limited

determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939." §1014(b)(9).

[117] § 2043(a).

[118] § 743(b)(2).

[119] *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017).

partnership interest to a lifetime charitable lead annuity trust (CLAT) that would pay an annuity amount to charity for the lifetime of the decedent with the remainder passing to the decedent's sons at the death of the decedent. The son may not have had the authority to make the transfer to the CLAT because the power of attorney only allowed gifts to the principal's issue up to the federal gift tax annual exclusion. The value of the taxable gift of the remainder interest to the sons was calculated with a 25% valuation discount on the limited partnership interest due to lack of control and marketability. The decedent died 7 days after the contribution to the CLAT.

b. The IRS argued that the $10 million of contributed assets were includible in the decedent's estate under the following Code sections: (i) section 2036(a)(1) (retained enjoyment of income); (ii) section 2036(a)(2) (retained right in conjunction with any person to designate who could enjoy the property or its income; (iii) section 2038 (power to alter, amend, revoke, or terminate the transfer at the decedent's death; and (iv) section 2035(a) (transfer of property within three years of death that otherwise would have been includible sections 2036-2038 of the Code or section 2042 (inclusion of life insurance proceeds). Interestingly, the taxpayer did not contest the application of section 2036(a)(2) or argue that the bona fide transfer for full and adequate consideration exception to section 2036 applied. Rather, the taxpayer contended that section 2036 and 2038 could not apply because the decedent did not own any interest in the FLP at death.

c. The Tax Court agreed that section 2036(a)(2) applied. In the majority opinion, the Tax Court held that (i) the decedent, in conjunction with all other partners, could dissolve the partnership, and (ii) the decedent, through her son acting under the power of attorney and as a general partner of the FLP, could control the amount and timing of distributions. In previous cases, the courts had applied section 2036(a)(2) to certain FLP cases,[120] but this was the first application of section 2036(a)(2) where the decedent exclusively owned a limited partnership interest.

d. The majority opinion goes on to explain that the inclusion amount under section 2036 must be adjusted under section 2043(a) of the Code. Although the majority opinion admits that "read in isolation" section 2036(a)(2) would require that the amount includible in the estate would be the full date of death value of the cash and securities transferred to the FLP, it asserts that section 2036(a)(2) must be read in conjunction with section 2043(a) of the Code.

(1) Section 2043(a) of the Code provides, in pertinent part, if there is a transfer of an interest includible under section 2036 "for a consideration in money or money's worth, but is not a bona fide sale for adequate and full consideration in money or money's worth,"[121] then the amount includible in the gross estate is "only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent."[122]

(2) As such, the amount includible under sections 2036 and 2043 of the Code is the valuation discount due to lack of control and marketability—the value of the

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[120] *See Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff'd*, 417 F.3d 468 (5th Cir. 2005) and *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209 (both cases involved a decedent owning a general partnership interest). *But see Kimball v. U.S.*, 371F.3d 257 (5th Cir. 2004), *rev'g*, 244 F. Supp 2d 700 (N.D. Tx. 2003) and *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74.

[121] § 2043(a).

[122] *Id.*

contributed assets ($10 million) less the value of the limited partnership interest received ($7.5 million due to valuation discount of 25%), assuming no change in the value of the transferred assets. The majority opinion refers to this amount as the "hole" in the doughnut. The court refers to the limited partnership interest as the "doughnut," which would be included in the gross estate if the transfer was deemed void or included in the gift amount if the gift is recognized. The court concluded, in this instance, that the transfer was void or revocable, and as such, the limited partnership's assets were includible in the estate of the decedent.

(3) If there had been a change in the value of the transferred assets between the transfer and the date of death, the net inclusion amount would be increased by any appreciation or reduced by any depreciation. According to the majority opinion:

> Changes in the value of the transferred assets would affect the required inclusion because sec. 2036(a) includes in the value of decedent's gross estate the date-of-death value of those assets while sec. 2043(a) reduces the required inclusion by the value of the partnership interest on the date of the transfer. To the extent that any post-transfer increase in the value of the transferred assets is reflected in the value of the partnership interest the decedent received in return, the appreciation in the assets would generally be subject to a duplicative transfer tax. (Conversely, a post-transfer decrease in value would generally result in a duplicative reduction in transfer tax.)[123]

(4) In other words, the date of death value of the limited partnership interest would also be included under section 2033 of the Code, so all of the post-contribution appreciation would also be subject to estate tax. Thus, more value may be included in the gross estate than if the decedent had never contributed assets to the FLP.

e. The concurring opinion, which was joined by seven judges, asserts that the planning involved in this case is "best described as aggressive deathbed tax planning." It then agrees that section 2036(a)(2) of the Code applies because the decedent made a transfer of the $10 million in cash and securities (to the partnership), but the decedent "retained the proverbial 'string' that pulls these assets back into her estate." However, as the concurring opinion provides:

> This is where I part company with the Court, because I do not see any "double inclusion" problem. The decedent's supposed partnership interest obviously had no value apart from the cash and securities that she allegedly contributed to the partnership. The partnership was an empty box into which the $10 million was notionally placed. Once that $10 million is included in her gross estate under section 2036(a)(2), it seems perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities.
>
> This is the approach that we have previously taken to this problem. *See Estate of Thompson*, 84 T.C.M. (CCH) at 391 (concluding that the decedent's interest in the partnership had no value apart from the assets he contributed to the partnership); *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, 83 T.C.M. (CCH) 1641, 1654; cf. *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1020 (1963) (holding that a decedent's retained interest in her own property cannot constitute

[123] *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), fn. 7.

> consideration under section 2043(a)). And this is the approach that I would take here. There is no double-counting problem if we read section 2036(a)(2), as it always has been read, to disregard a "transfer with a string" and include in the decedent's estate what she held before the purported transfer—the $10 million in cash and securities.
>
> Rather than take this straightforward path to the correct result, the Court adopts as the linchpin of its analysis section 2043(a). Neither party in this case advanced any argument based on section 2043(a); indeed, that section is not cited in either party's briefs. And as the Court recognizes, *see* op. Ct. p. 28, we have not previously applied section 2043(a), as the Court does here, to limit the amount includible in a decedent's gross estate under section 2036(a). *See*, *e.g.*, *Estate of Harper*, 83 T.C.M. (CCH) at 1654 (ruling that section 2043(a) "is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration"). [124]

f. While asserting that section 2043(a) is inapplicable in this case, the concurring opinion goes on to opine that even if section 2043(a) did apply, it is not clear that the decedent's partnership interest (the result of a now disregarded transfer) can constitute consideration in money or money's worth within the meaning of section 2043(a).

g. The *Powell* majority opinion was not joined by a majority of the Tax Court judges. Eight judges represented the majority opinion, seven judges agreed with the result but rejected the double inclusion issue, and two judges concurred with the result only.

2. The *Moore* Opinion

a. In *Estate of Moore v. Commissioner*,[125] the Tax Court held that section 2036(a)(1) applied to assets that the decedent (Mr. Moore) had transferred to a limited partnership four months before his death after he had been admitted to hospice care. The primary asset in question was a family farming business that the decedent was in the process of selling when he became ill. The decedent transferred 80% of the family farming business to the "Moore FLP," in return for a 95% limited partnership interest, and the other 20% was owned by the decedent's living trust. A Management Trust (two of his children were the co-trustees) was the 1% general partner of the Moore FLP. The decedent's 4 children collectively owned the other 4% of limited partnership interests. A few months later, the family farm business was sold for $16.5 million, and the proceeds were split among the Moore FLP and living trust according to their respective 80% and 20% interests in the business.

b. After the sale, Mr. Moore made a series of transfers of the proceeds including (i) $220,000 to the estate planning attorney payable by the Moore FLP and revocable trust; (ii) $500,000 "advances" to each of the decedent's four children from the Moore FLP; (iii) $500,000 gift to Mr. Moore's grandson, and (iv) $2 million non-pro rata distribution from the Moore FLP to the living trust to pay various expenses of the decedent including the resulting income tax liability from the sale of the business.

c. Soon thereafter, the living trust sold its 95% limited partnership interest in Moore FLP to an IDGT for $5.3 million based on the partnership's net asset value less a 53%

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[124] *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), concurring opinion.

[125] *Estate of Moore v. Commissioner*, T.C. Memo 2020-40.

valuation discount. The IDGT purchased the partnership interest with $500,000 gifted from the living trust and promissory notes. Later that month, Mr. Moore passed way.

d. In coming to its conclusion, the Tax Court applied the *Estate of Bongard*[126] test which provides section 2036(a)(1) applies to a transfer of a partnership interest if: (i) a transfer of assets was made to a partnership; (ii) the transfer was not a bona fide sale for adequate and full consideration; and (iii) the decedent retained an interest or right in the transferred property. The court concluded there was not sufficient evidence of legitimate and significant non-tax reasons for the establishment of the partnership and the transfer of the assets. As a result, the transfer was not a bona fide sale. Further, the court concluded Mr. Moore had retained an interest in the transferred assets as evidenced by his continued occupancy of the property, his use of the proceeds from the sale for his personal needs, and his unchanged relationship with the transferred as he had *de facto* control over the management of the partnership.

e. The Tax Court then revisited the partial consideration offset under section 2043(a) that was addressed in *Estate of Powell*, which must be part of the calculus now. As explained by the court:[127]

> Until recently, our analysis of the estate's situation could end here. Our finding that the transfer of most of the farm to the FLP didn't change its inclusion in Moore's gross estate would just mean that the proceeds from the farm's sale to the Mellons would be included in Moore's gross estate, and that the value of the interest in the FLP attributable to the contribution would be excluded. *See, e.g.*, *Estate of Thompson*, 84 T.C.M. (CCH) at 391. Excluding the value of the partnership interest from Moore's gross estate might appear to be the right result because it would prevent its inclusion in the value of the estate twice. The problem is that there is nothing in the text of section 2036 that allows us to do this. Nothing in section 2036 allows us to exclude anything from the estate, only to include the value of the transferred property.
>
> But then we decided *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017). We discovered and analyzed there, apparently for the first time, section 2043(a) of the Code as it applies to family limited partnerships. In *Estate of Powell v. Commissioner*, 148 T.C. at 404 , the taxpayer had transferred assets with a value of $10 million to a limited partnership in exchange for a 99% interest in the partnership as a limited partner. We held that section 2036 compelled inclusion of this $10 million in the gross estate. We also carefully observed, however, that section 2033 seemed to compel inclusion of the partnership interest in the estate. That's where section 2043(a) does its work--it let us subtract the value of the partnership interest that the estate held.

f. The formula set out by the court is essentially the following:[128]

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[126] *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005).

[127] *Estate of Moore v. Commissioner*, T.C. Memo 2020-40, at 15-16.

[128] $\mathbf{V_{included} = C_d + FMV_d - C_t}$: $\mathbf{V_{included}}$ = value that must be added to the gross estate; $\mathbf{C_d}$ = date-of-death value of the consideration received by the decedent from the transaction that remains in his estate under section 2033; $\mathbf{FMV_d}$ = fair market value at date of death of property transferred by the decedent whose value is included in the gross estate under section 2036; and $\mathbf{C_t}$ = consideration received by the decedent at the time of the transfer, which has to be subtracted under section 2043(a). *Id.* at 16.

Value (at death) of partnership interest of decedent that remains in the estate—§ 2033
PLUS
Value (at death) of property transferred by decedent which is included—§ 2036
LESS
Value (at transfer) of partnership interest received by decedent during life—§ 2043(a)
NET INCLUSION AMOUNT IN GROSS ESTATE

g. The courts set outs the following five examples:[129]

Example 1: (Constant Values). During life, decedent contributed land valued at \$1,000 to a partnership in exchange for interests worth \$500. The transfer is subject to inclusion under sections 2035-2038. There were no changes in value between the contribution date and the date of death. As a result, the net inclusion amount equals \$1,000 (\$500 + \$1,000 - \$500).

Example 2: (Inflating Values). Same facts as Example 1, except that the date of death values of the land and the partnership interests have doubled between the contribution date and date of death. As a result, the net inclusion amount equals \$2,500 (\$1,000 + \$2,000 - \$500).

Example 3: (Declining Values). Same facts as Example 1, except that the date of death values of the land and the partnership interests have depreciated by 50% between the contribution date and date of death. As a result, the net inclusion amount equals \$250 (\$250 + \$500 - \$500).

Example 4: (Discounted Interest, But Simple). Similar facts as Example 1, except that the decedent received a limited partnership interest subject to a 25% discount in exchange for the contribution of land. The value of the partnership interest is \$750 after the contribution. There were no changes in value between the contribution date and the date of death. As a result, the net inclusion amount equals \$1,000 (\$750 + \$1,000 - \$750).[130]

Example 5: (Discounted Interest, But Not Simple). Same facts as Example 4 except the partnership sells the land for \$1,000. The partnership makes a distribution of \$400 to the decedent. Assuming the \$400 distribution is still in the estate then het net inclusion amount is \$1,100 (\$400 distribution under § 2033 + \$450 for partnership interest under § 2033 [\$600 gross value less 25% valuation discount] + \$1,000 for the land under § 2036 - \$750 value of partnership interest on date of contribution).[131]

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[129] *Id.* at 16-17

[130] This seems to be the same as Example 1 except the partnership interest received by the decedent in Example 1 is effectively subject 50% discount (partnership interest on date of transfer was worth \$500).

[131] The opinion assumes that the inclusion amount is \$1,000 for the contributed land, but the land was sold and \$400 of the proceeds were distributed to the decedent. Should the amount included have been \$600? What if the land had been sold for a gain of \$1,200, would this require \$1,200 to be included in the formula?

h. In summary, the section 2043 analysis results in "double inclusion" if the partnership assets increase in value between contribution and date of death, but a lower value if the assets decrease during that period.

i. The opinion goes on to make some additional modifications. First, the opinion provides that the variable which is the value on date-of-death of the consideration received in the transfer (partnership interest that remains in the estate), is "not limited by tracing rules," meaning that "whatever is left of the original consideration in an estate is included, but so are the proceeds from its later sale because section 2033 includes all property that a decedent owns in his gross estate."[132] Presumably, this states the obvious ($400 has been distributed from the sale of the land, which represents a partial return on the partnership interest). Also, it could refer to the fact that if the decedent had sold the partnership interest to an IDGT in exchange for an installment note, the value of the installment would be included under section 2033 in this calculation of the net inclusion amount. The opinion then goes on to say, "This also means that any property that leaves an estate after a transfer governed by section 2036 but before a decedent's death is *not* generally included in the gross estate."[133] Again, perhaps the opinion is stating the obvious, but if a taxpayer made a gift of the partnership interest received in the contribution, the partnership interests would not be included in the estate under section 2033 and notably, there would be no adjustment to the outside basis of the gifted partnership. This could create a significant and lasting issue for the partners, as discussed below.

C. Section 2036: Inside/Outside Basis Problem

1. As noted above, section 2036 mandates estate tax inclusion of the property held by the partnership. Section 1014(b)(9) provides a basis adjustment to those assets at fair market. If partial consideration is received on the original transfer of property to the partnership, the *Powell* and *Moore* opinions have ruled that the inclusion amount must be reduced under section 2043(a) by the value of the consideration (partnership interest) received at the time of the original transfer. It's unclear whether the section 2043(a) reduction will reduce the basis adjustment under section 1014(b)(9) or if it is just a nominal reduction that simply reduces the amount of estate inclusion. It appears that the latter is true. Section 1014(a) provides, in pertinent part, "Except as provided in this section, the basis of property in the hands of a person acquiring the property from a decedent shall … be … the fair market value of the property at the date of the decedent's death."[134] There is no provision in section 1014 that provides for a reduction from fair market value. For purposes of the examples below, it is assumed that the basis adjustment to the partnership assets under section 1014(b)(9) will be at fair market value, without any reduction under section 2043(a).

2. The *Powell* and *Moore* opinions make clear that if the consideration (partnership interest) received on the transfer of the property is still held by the decedent on date of death, the partnership interest will also be included in the gross estate under section 2033, and the partnership interest will get a basis adjustment under section 1014(b)(1) of the Code. The resulting outside basis of the partnership interest may or may not equal to the inside basis of the partnership assets. Further, if a section 754 election is in place, section 743(b) may require an inside basis adjustment that could reduce the basis with respect to the transferee of the partnership interest.

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[132] *Estate of Moore v. Commissioner*, T.C. Memo 2020-40, at 17.

[133] *Id.*

[134] § 1014(a)(1). The basis adjustment can, of course, be determined under section 2032, 2032A, and 2031. §§ 1014(a)(2), (3) and (4).

Example: D and D's child, C, create the DC Partnership. D contributes Asset D which has an adjusted basis of $0x and a fair market value of $99x, in exchange for a 99% limited partnership interest. C contributes Asset C which has an adjusted basis of $0x and a fair market value of $1x in exchange for a 1% general partnership interest. At the time of contribution, the 99% limited partnership interest is subject to a 40% valuation discount for a value of $59.4x. Upon D's death, the assets in the DC Partnership have doubled in value to $200x, and D continued to own the 99% limited partnership interest, subject to a 40% valuation discount. Assume section 2036 applies on D's death.

Pursuant to the *Powell* and *Moore* formula, the amount of inclusion is, as follows:

99% LP interest at 40% discount ($118.8x = 99% * $200x * 60%)—§ 2033
PLUS
Partnership assets ($200x)—§2036
LESS
99% LP interest on contribution at 40% discount ($59.4x = 99% * $100x * 60%)—§2043
NET INCLUSION AMOUNT = $259.4x

The resulting inside and outside basis is as follows:

Inside basis of partnership assets = $200x—§ 1014(b)(9)
Outside basis of 99% LP interest = $118.8x—§ 1014(b)(1)
Outside basis of 1% GP interest = $0x

When the inside basis of partnership assets are higher than the outside basis of the partners, then it will eventually result in the loss of basis or capital gain to the partners. If the DC Partnership liquidates and distributes Assets D and C to the partners, the adjusted basis of distributed assets will be reduced to $118.8x (the outside basis of the partners).[135] Alternatively, if the DC Partnership sells Assets D and C for $200x and distributes the proceeds to the partners, then the partners will recognize gain of $81.2x ($79.2x gain to the transferee of the 99% LP interest and $2x gain to the 1% general partner).[136]

If in this example DC Partnership has a section 754 election in place, under section 743(b) of the Code, the 99% LP interest transferee's share of inside basis will be reduced by $79.2x (99% * $200x * 40%). Because this inside basis adjustment only applies to the LP transferee, the LP transferee will bear the entire tax burden of this nominal inside basis reduction. For example, if the DC Partnership sells all of the assets of the partnership for $200x, $79.2x of gain will be allocated to the 99% LP transferee.[137]

3. This inside/outside basis discrepancy becomes even more pronounced if the taxpayer transfers the partnership interest during lifetime.

[135] § 732(b).

[136] § 731(a)(1).

[137] *See* II.M.2. of the Subchapter K(ryptonite) Outline.

Example: Same facts as the example above except shortly after the contribution of Asset D, D gifts the 99% LP interest to a trust. The amount of net inclusion, of course, is reduced because the 99% LP interest is no longer included in the gross estate:

$0—§ 2033
PLUS
Partnership assets ($200x)—§2036
LESS
99% LP interest on contribution at 40% discount ($59.4x = 99% * $100x * 60%)—§2043
NET INCLUSION AMOUNT = $140.6x

The resulting inside and outside basis is as follows:

Inside basis of partnership assets = $200x—§ 1014(b)(9)
Outside basis of 99% LP interest = $0x—§ 1015
Outside basis of 1% GP interest = $0x

The inside/outside basis discrepancy is even greater now. A liquidation of the partnership will result in a loss of $200x in basis, and a sale of the partnership assets followed by a distribution of the proceeds will result in the recognition of $200x of gain. Under such circumstances, the partners are better off keeping the partnership in existence as long as possible and hoping that the basis discrepancy can be resolved, in whole or in part, by getting an outside basis adjustment at death under section 1014.

4. If, in the example above, D did not gift the LP interest but sold the 99% LP interest to an IDGT in exchange for an installment note, upon D's death the net inclusion amount would be as follows, assuming no valuation discounts to the face value of the installment note (although the inside/outside basis discrepancy would still be the same):

$59.4x Installment Note ($59.4x)—§ 2033
PLUS
Partnership assets ($200x)—§2036
LESS
99% LP interest on contribution at 40% discount ($59.4x = 99% * $100x*60%)—§2043
NET INCLUSION AMOUNT = $200x

D. Section 734 Is Not a Solution

1. At first blush, a possible solution to this inside/outside basis conundrum is in section 734(b), which provides:[138]

In the case of a distribution of property to a partner by a partnership with respect to which the election provided in section 754 is in effect or with respect to which there is a substantial basis reduction, the partnership shall increase the adjusted basis of partnership property shall—

[138] § 734(b)(1).

(1) increase the adjusted basis of partnership property by

(A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1), and

(B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution … over the basis of the distributed property to the distributee, as determined under section 732.

2. As noted in the examples above, distributions of money in excess of outside basis causes recognition of gain and distributions of higher basis assets to lower outside basis distributees causes a reduction of basis. This is exactly the situation described in section 734(b). As noted in II.M.3. of the Subchapter K(ryptonite) Outline, basis adjustments under 734(b) are made to the common basis of the partnership, so basis adjustments are for the benefit of all of the partners. The unusual fact in this instance, however, is that the adjusted bases of the partnership assets are already equal to their fair market value. As discussed in II.M.4. of the Subchapter K(ryptonite) Outline, positive basis adjustments are first allocated to assets in the same class with unrealized appreciation in proportion to their relative appreciation. In this instance there is no unrealized appreciation. However, the Treasury Regulations go on to instruct, "Any remaining increase must be allocated among the properties within the class in proportion to their fair market values." So, theoretically, the recognized gain or lost basis can result in inside basis being increased to more than the value of the partnership property. In such case, it might be possible to sell partnership property at a loss, but there may be no outside basis to recognize the loss.[139]

Example: In the last two examples, upon D's death, the resulting inside and outside basis is:

Inside basis of partnership assets = $200x—§ 1014(b)(9)
Outside basis of 99% LP interest = $0x—§ 1012
Outside basis of 1% GP interest = $0x

Assume the partnership sells $150x of partnership property and distributes the $150x of proceeds. The sale does not result in any capital gain, but the distribution of $150x results in $150x of gain because the partners have no outside basis. Section 734(b) would allow the partnership to increase the adjusted basis of the remaining partnership property from $50x (what remains after the sale) to $200x. The partnership can sell the property for a loss of $150x. However, none of the partners are able to recognize that loss because they do not have any outside basis. This loss remains suspended until such time as there is outside basis.

3. Alternatively, the partners could contribute low basis assets to the partnership to receive the benefit of the inside basis adjustment. The end result is a basis strip and shift (as discussed above) and the partners are still in the same economic position.

[139] § 704(d).

Example: Same situation as above:

Inside basis of partnership assets = $200x—§ 1014(b)(9)
Outside basis of 99% LP interest = $0x—§ 1012
Outside basis of 1% GP interest = $0x

The partners contribute Asset E, in proportion to their percentage interest in the DC Partnership. Asset E has an adjusted basis of zero and fair market value of $200x. After the contribution, DC Partnership has (i) Assets D and C which collectively have and adjusted basis of $200x and fair market value of $200x; and (ii) Asset E (zero adjusted basis and fair market value of $200x). DC Partnership distributes Assets D and C to the partners. As a result, the inside basis of Assets D and C, now in the hands of the partners, is reduced to zero. Assuming DC Partnership has a section 754 election in place, the partnership can increase the basis of Asset E to $200x.

The partners are in the same situation as before, owning partnership interests with no outside basis, and a partnership that has assets with $200x in basis. However, there has been a basis shift. Asset E now has basis when before this transaction it did not, perhaps desirable to the partners for some other reason.

V. DISREGARDED ENTITIES

A. Introduction

1. As discussed, when a LLC is a disregarded entity owned by a deemed owner and deemed-owned trust, all three of the persons are treated as a single taxpayer for federal income tax purposes. As such, all transfers and transactions between and among them are also ignored for income tax purposes under Revenue Ruling 85-13, and from a tax reporting standpoint, there is no need to deal with the complexities of partnership taxation. In addition, as discussed in IV.B. of the Subchapter K(ryptonite) Outline, the disregarded entity and its shares are treated much like partnerships for transfer tax purposes (allowing for valuation discounts). For all other legal purposes, the LLC, deemed owner, and the deemed-owned trust are separate entities. It can be a powerful combination for planning purposes.

2. If proposed section 1062 or other similar provision is enacted, some of the planning that can be accomplished with disregarded entities could be curtailed. Section 1062 would not eliminate the use of disregarded entities, but it would force practitioners to consider whether certain transactions would be considered taxable events if a deemed owner or deemed-owned trust were treated as separate taxpayers.

3. Given that grantor trust status must necessarily terminate with the death of the grantor, all disregarded entities owned by a grantor and one or more grantor trusts will be converted to another type of entity upon the death of the grantor (unless, in theory, the grantor's interest is transferred to the trust and the trust is the only other member of the LLC). It is important then to understand the tax consequences of the conversion of the disregarded entity to (most likely) a partnership.

B. Conversions with Disregarded Entities

1. Conversion of Disregarded Entity to Partnership

a. In Revenue Ruling 99-5,[140] the IRS provided guidance on the tax issues involved in a conversion of a disregarded entity to a partnership. The ruling addresses 2 situations with respect to a wholly-owned LLC that is disregarded for tax purposes and that is initially owned by a single member A. The ruling assumes that the LLC has no liabilities, the assets are not subject to any indebtedness, and all of the assets are capital assets or property described in section 1231 of the Code.

b. In situation 1, B purchases 50% of A's ownership in the LLC for $5,000. The ruling concludes that the LLC is converted to a partnership when B purchases the interest in the LLC from A. The purchase of the LLC interest is treated for tax purposes as if B purchased 50% of each of the LLC's assets (which are, in turn, treated as if held by A for tax purposes). Immediately thereafter, A and B are deemed to contribute their respective interests in those assets to a newly formed partnership. Under such treatment, the ruling further provides:

(1) Member A recognizes gain or loss on the deemed sale under section 1001 of the Code. However, there is no further gain or loss under section 721(a) of the Code for the contribution of asset to the partnership in exchange for partnership interests in the newly formed entity.

(2) Under section 722 of the Code, B's outside basis in the partnership is $5,000, and A's outside basis is equal to A's basis in A's 50% share of the assets in the LLC. Under section 723 of the Code, the partnership's tax basis in the assets is the adjusted basis of the property in A and B's hands immediately after the deemed sale.

(3) Under section 1223(1) of the Code, A's holding period for the partnership interest includes his or her holding period in the assets held by the LLC, and B's holding period for the partnership interests begins on the day following the date of B's purchase of the LLC interest from A.[141] Under section 1223(2) of the Code, the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

c. In situation 2, B contributes $10,000 in the LLC for a 50% ownership interest in the LLC. In this instance, as in the previous situation, the ruling concludes that the LLC is converted to a partnership when B contributes the cash to the LLC in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to a newly formed partnership. Under such treatment and facts, the ruling provides:

(1) There is no gain or loss to A or B under section 721(a) of the Code.

(2) Under section 722 of the Code, B's outside basis is equal to $10,000, and A's outside basis is his or her basis in the assets of the LLC which A is treated as contributing to the new partnership. Under section 723 of the Code, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of

[140] Rev. Rul. 99-5, 1999-1 C.B. 434.

[141] The ruling cites Rev. Rul. 66-7, 1966-1 C.B. 188.

the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.

(3) Under section 1223(1) of the Code, A's holding period for the partnership interest includes A's holding period in the LLC assets deemed contributed when the disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section 1223(2), the partnership's holding period for the assets transferred to it includes A 's holding period.

d. Unfortunately, the foregoing ruling does not address (i) non-taxable transactions like sales or exchanges of a disregarded entity interests between a grantor and his or her grantor trust (situation 1 is a taxable sale) or (ii) contributions of assets to a disregarded entity by a grantor or grantor trust. Under those circumstances, how should the tax basis be allocated among the grantor and the grantor trust? It seems that given the IRS's position in Revenue Ruling 85-13 that grantor trusts are "ignored" or also disregarded, that the unitary basis rules would apply in such a way that if B was a grantor trust in the situations described in Revenue Ruling 99-5, B's outside would not be $5,000/$10,000 respectively. Rather, the aggregate basis of A (the grantor) and B (the grantor trust) would be allocated pursuant to the unitary basis rules, as discussed in more detail above (essentially B would receive a portion of A's basis in the transferred asset). Further, the ruling does not address the conversion of a disregarded entity to a partnership when grantor trust status is lost and the trust holds only a portion of the entities interest. Again, it seems that an allocation of the unitary basis is warranted, as discussed above.

2. Conversion of Partnership to Disregarded Entity

a. In Revenue Ruling 99-6,[142] the IRS provided guidance on the tax issues involved in a conversion of partnership to a disregarded entity. The ruling addresses 2 situations with respect to an LLC that is classified as a partnership but becomes a disregarded entity when a transaction consolidates all of the ownership with a single member. The ruling provides that the LLC has no liabilities, and the assets are not subject to any indebtedness.

b. In situation 1, A and B are equal partners in an LLC taxed as a partnership. A sell's his or her entire interest in the LLC to B for $10,000. The ruling concludes the partnership terminates under section 708(b)(1)(A) when B purchases A's entire interest. A must treat the transaction as a sale of A's partnership interests, and with respect to the treatment of B, there is a deemed liquidating distribution of all of the assets to A and B, followed by B treated as acquiring the assets deemed to have been distributed to A in liquidation of A's interests. Under such treatment:

(1) A has gain or loss resulting from the sale of the partnership interest under section 741 of the Code. As discussed in II.U.1. of the Subchapter K(ryptonite) Outline, section 741 of the Code provides that gain or loss resulting from the sale or exchange of an interest in a partnership shall be recognized by the transferor partner, and that the gain or loss shall be considered as gain or loss from a capital asset, except as provided in section 751 of Code (relating to "hot assets," unrealized receivables and inventory items).

(2) B's basis in the assets attributable to A's one-half interest in the partnership is $10,000 under section 1012 of the Code. B does not get to retain the holding period

[142] Rev. Rul. 99-6, 1999-6 I.R.B. 6.

of the partnership on such assets deemed liquidated and distributed to A under section 735(b) of the Code. Rather, these are newly acquired assets, and B's holding period for these assets begins on the day immediately following the date of the sale.

(3) With respect to B's portion of the deemed liquidation, B will recognize gain or loss (if any) under section 731(a) of the Code (generally, no gain or loss except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution, assuming there are no "hot assets" in the partnership). B's basis in the assets received in the deemed liquidation of B's interest is determined under section 732(b) of the Code (generally, the adjusted basis of B's interest in the partnership, reduced by any money distributed in the same transaction). Under section 735(b) of the Code, B's holding period for the assets includes the partnership's holding period for such assets.[143]

c. In situation 2, C and D are equal partners in an LLC taxed as a partnership. C and D sell their entire interests in the LLC to E, an unrelated person, for $20,000 ($10,000 each). As under the previous situation, the ruling concludes the partnership terminates under section 708(b)(1)(A) when E purchases all of the LLC interests. C and D must treat the transaction as a sale of their respective partnership interests, and with respect to E, there is a deemed liquidating distribution of all of the assets to C and D, followed by E treated as acquiring all of the former assets of the partnership from C and D.

(1) C and D have gain or loss under section 741 of the Code.

(2) E's basis in the assets in the partnership is $20,000 under section 1012 of the Code, and E's holding period begins on the day immediately following the date of the sale.

d. In typical estate planning transactions, a conversion from a partnership to a disregarded entity could occur in a taxable transaction (e.g., sale of a partnership interest from a non-grantor trust to the only other partner) or in a non-taxable transfer (e.g., the distribution of a partnership interest from a non-grantor trust to a beneficiary that is the only other partner or in a gratuitous transfer of the partnership interest to the only other partner. In addition, a conversion from a partnership to a disregarded entity could occur if an LLC had two members, a grantor and a non-grantor trust, and the trust converted to a non-grantor trust. This, as discussed, is likely not a taxable event. Presumably, the Revenue Ruling 99-6 would apply to the taxable transactions, but it is unclear how they might apply to the non-taxable transactions.

C. Possible Planning Opportunities

1. Terminating a GRAT Before the End of the Term

a. When section 1062 was proposed, there was some concern that it would apply to pre-enactment grantor trusts like grantor retained annuity trusts (GRATs). Such that, for example, if annuity payments of the GRAT were made in kind with appreciated property, then it would be a taxable event and gain would be recognized. If the assets in the GRAT have appreciated significantly above the section 7520 rate that was in effect when the GRAT was funded, then an early termination of the GRAT might be desirable, especially when there is always the risk that the

[143] Except for inventory items. *See* §735(a)(2).

grantor may die prior to the end of the annuity term. The Treasury Regulations, however, prohibit commutation (prepayment) of the interest of the term holder.[144]

b. If the holder of the remainder interest of GRAT is a grantor trust, one possible way of terminating the GRAT is to use an LLC that is a disregarded entity. Pursuant to this idea, in exchange for units in the LLC, the grantor would contribute the right to receive the remaining annuity payments and the grantor trust would contribute its remainder interest to the LLC. The value of the respective contributions would be determined based on the value of the GRAT assets and the actuarial value of the remaining annuity payments, as determined under section 7520 at the time of the contributions. Even though the LLC is disregarded for federal income tax purposes, the LLC is a separate legal entity from the grantor and the grantor trust. As such, when the LLC owns both the term interest and the remainder interest, all of the interests in the GRAT are held a single owner and the interests merge, thereby terminating the GRAT. The end result is the grantor and grantor trust (proportionate to the value of their contributions) collectively own 100% of the units in the LLC, and the LLC directly owns all of the assets of the GRAT.

c. If section 1062 or other similar provision is not enacted, then the contribution, termination of the GRAT, and the liquidation of the LLC will not be a taxable event under Revenue Ruling 85-13. If section 1062 or other similar provision is enacted, then, as discussed earlier, the parties may need to wait 2 years or more after contribution to the LLC to avoid the possible application of the disguised sale rules, assuming the LLC would be treated as a partnership under section 1062 (although disregarded for all other purposes).

2. Preferred S Corporation Freeze

a. S corporations cannot have more than one class of stock, which generally requires that all of the outstanding stock must have identical rights to distributions and liquidation proceeds, but the S corporation may have voting and non-voting shares.[145] In addition, partnerships are not eligible S corporation shareholders.[146] Because of the single class of stock requirement, S corporation shareholders are not able bifurcate their economic interests into preferred and common interests and effectuate transactions similar to a preferred partnership freeze or reverse freeze.

b. S corporation shareholders may be able to create preferred and commons interests through a disregarded entity. Pursuant to this idea, S corporation shareholder would create a wholly-owned LLC that is treated as a disregarded entity and contribute his or her S corporation shares to the entity. The disregarded entity would then recapitalize its shares into preferred and common shares, thereby allowing the taxpayer to do a forward or reverse freeze transaction with his or her IDGT. While the taxpayer is alive and the trust remains a grantor trust, the individual taxpayer should continue to be deemed the eligible S corporation shareholder.[147] The IRS has ruled that an S corporation may be owned by a partnership or a limited liability company (or a combination of them) as long as the partnership and limited liability company are disregarded for

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[144] Treas. Reg. § 25.2702-3(d)(5).

[145] *See* § 1361(b)(1)(D), Treas. Reg. § 1.1361-1(l)(1).

[146] *See* § 1361(b)(1)(B).

[147] *See* § 1361(c)(2)(A)(i) allowing grantor trusts of U.S. citizens and residents to be S corporation shareholders.

income tax purposes.[148] If the disregarded entity is liquidated during the life of the grantor, then the S corporation shares will be distributed among the grantor and the trust, which will either remain a grantor trust or become either an electing small business trust[149] or a qualified subchapter S trust.[150]

c. If, however, the grantor dies prior to the liquidation of the disregarded entity, then an issue arises as to whether the entity will be deemed to have converted to a partnership (as an entity owned by a non-grantor trust and the estate of the taxpayer), thereby terminating the S corporation status of the corporation. This termination might be avoided, as follows:

(1) If the operating agreement of the disregarded entity requires an immediate termination and liquidation upon the death of the grantor, then the LLC would, in theory, cease to exist and the assets (the S corporation shares) would immediately be divided among the estate of the decedent and the trust (that must also qualify as an ESBT or QSST).[151] In most forward freeze transactions, the grantor would hold a preferred interest that had a fixed liquidation amount, and the trust would hold any excess value. The value of the S corporation shares would need to be determined in allocating the fixed liquidation amount to the estate, with any excess shares passing to the trust.

(2) Another possible way of avoiding S corporation termination is to ensure that upon the death of the taxpayer, the LLC shares held by the decedent would pass directly to the trust, thereby unifying 100% of the LLC ownership in the trust (which is either an ESBT or QSST). It appears that bequeathing the shares under the decedent's Will may still cause termination of S status. The IRS has ruled that if a corporation's stock is subject to the possession of the executor or administrator of the decedent's estate, the estate is considered a shareholder as of the date of death, notwithstanding the fact that applicable state law provides that legal title to the stock passes directly to the heirs under the Will.[152] However, termination might still nonetheless be avoided by providing that the LLC interests pass directly to the trust outside of probate. The operating agreement could provide an immediate transfer of the grantor's interest in the LLC to the trust, similar to a transfer on death provision or beneficiary designation. Whether a transfer on death provision in a revocable living trust (as opposed to under the Will) would also be effective is unclear.

d. Even if there is a deemed termination of S corporation status, The IRS has granted relief in circumstances where the S corporation stock was held by disregarded entities and the death of the grantor caused the termination. In PLRs 201730002 and 200841007, the IRS concluded that a termination of S corporation status caused by the death of the grantor—during life the taxpayer had created grantor trusts that held shares in a disregarded entity that, in turn, owned S corporation shares—was inadvertent within the meaning of section 1362(f) of the Code. In both rulings, the taxpayer was granted relief and S corporation status was maintained after the death of

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[148] PLR 200513001.

[149] § 1361(c)(2)(A)(v).

[150] § 1361(d)(1)(A) treating such qualified subchapter S trusts as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i).

[151] *See Guzowski v. Commissioner*, T.C. Memo 1967-145. A partnership that ceased to exist based on the stated term in the partnership agreement was not deemed to be the shareholder. The partners were deemed to be the shareholders.

[152] Rev. Rul. 62-116, 1982-2 C.B. 207.

the taxpayer.[153] Of course, private letter rulings have no precedential value, so practitioners are advised to obtain a ruling in advance to ensure that S corporation status will not be terminated.

3. Eliminating Outstanding Installment Notes and Gain

a. As mentioned above, the conversion from grantor to non-grantor trust (e.g., death of the grantor) is treated as a transfer by the grantor of the underlying property in the trust. Often, the original transfer of the property is pursuant to an installment sale to an IDGT, with the purchase effectuated by a promissory note from the IDGT to the grantor and the IDGT's debt obligations collateralized by the transferred property. If the promissory note is outstanding at the time of conversion from grantor to non-grantor trust, gain will be recognized to the extent that the debt encumbering the property is in excess of its tax basis.[154]

b. Grantors and their IDGTs may be able to use disregarded entities to eliminate the potential gain and provide for a step-up in basis on the underlying assets upon the death of the grantor. To illustrate how this might be accomplished, consider an IDGT that holds an asset worth $100x and an adjusted basis of $0, but the asset is encumbered by a $50x liability of the IDGT to the grantor, as evidenced by an installment note (e.g., paying interest annually and with an outstanding principal amount of $50x) held by the grantor. If the grantor dies, (i) the promissory note would be includable in the grantor's estate and get a "step-up" in basis, (ii) the asset in the IDGT would be out of the grantor's estate but would not get a "step-up" in basis, and (iii) $50x of gain would have to be recognized by the estate because of the liability in excess of tax basis.

c. To avoid this result, the grantor and the IDGT could simultaneously contribute their respective interests in the property and the debt to a newly formed LLC. IDGT would contribute the asset, along with its $50x liability to grantor, to the LLC. Grantor would contribute the installment note with a principal amount of $50x. Assuming, the net value of the asset and the promissory note were both equal to $50x, IDGT and grantor would be equal (each 50% owners) members in the LLC, but the LLC would continue to be a disregarded entity because they are considered the same taxpayer. As such, the contribution of the asset (subject to the debt) and the promissory note should not have any tax ramifications.

d. The LLC, as a separate legal entity, now owns an asset with a gross value of $100x, has a debt liability of $50x, and it owns the right to receive the $50x debt. In other words, if a person has a debt but also owns the right to be paid on the debt, the debt should by law be extinguished. Further, because the LLC is disregarded and the members of the LLC are the same taxpayer due to the grantor trust rules, the extinguishment of the debt should have no tax ramifications. This leaves the LLC simply holding an asset worth $100x (and no liabilities) with the IDGT and grantor each owning 50% of the LLC.

e. Upon the death of the grantor, there is a deemed transfer of 50% of the LLC to the trust (no longer a grantor trust) which converts the disregarded entity to a partnership for tax purposes under situation 1 of Revenue Ruling 99-5. As discussed above, such a conversion

[153] *See also* PLRs 200237014, 200237011, 9010042, and 8934020 where the IRS ignored momentary ownership of a newly formed corporation's stock by a partnership during the process of incorporating the partnership or taking remedial measures.

[154] *See*, *e.g.*, *Crane v. Commissioner*, 331 U.S. 1 (1947). *See also* Treas. Reg. §§ 1.1001-2(a)(4)(v), 1.1001-2(c), *Ex. 5*, and Rev. Rul. 77-402, 1977-2 C.B. 222, in the partnership context.

is treated as an acquisition of the LLC assets by the members and a contribution of those assets to a new partnership. Significantly, if the conversion is treated this way, then for step-up in basis purposes, the estate does not own a 50% interest in a partnership, rather the estate is deemed to own 50% of the assets which are simultaneously contributed to a partnership at death. As such, the estate should be entitled to claim a step-up in basis under section 1014(a) of the Code for 50% of the value of the asset in the LLC without risk of losing basis due to valuation discounts.

f. Under sections 722 and 723 of the Code, the estate should have an outside basis in the LLC of $50x, and the LLC should have an inside basis of $50x on the asset which is worth $100x. Practitioners taking this position will likely want to report the inclusion of 50% LLC asset in the estate of the grantor, rather than a 50% interest in the LLC, and out of an abundance of caution, ensure that the LLC makes a section 754 election, entitling it to an inside basis adjustment under section 743(b), in case there is a question as to whether the LLC has $50x of inside basis on the asset.

VI. CONCLUSION

Partnerships, disregarded entities, and disregarded taxpayers (like grantors and grantor trusts) are the most flexible tools in income and estate planning. Unfortunately, flexibility often means complexity, and the results can be even more perplexing when income tax meets transfer tax. Hopefully, these materials will give planners insights on the myriad of ways that partnerships and disregarded taxpayers can be used to exchange assets, manage tax basis in sophisticated ways, defer and avoid taxes, and possibly be a solution to future legislative changes to transactions between deemed owners and their deemed-owned trusts.