VENN DIAGRAMS:
MEET ME AT THE INTERSECTION OF ESTATE & INCOME TAX
(PLANNING FOR THE ATRA-MATH)

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I. INTRODUCTION

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

1. The year 2013, with the enactment of the American Taxpayer Relief Act of 2012[2] ("ATRA") and the imposition of the 3.8% Medicare contribution tax on unearned passive income[3] (hereinafter, the "3.8% Medicare tax") that was enacted as part of the Health Care and Education Reconciliation Act of 2010 ("HCERA"),[4] which amended the Patient Protection and Affordable Care Act ("PPACA"),[5] will mark the beginning of a significant change in perspective for estate planners.

2. For years, estate planning entailed aggressively transferring assets out of the estate of high-net-worth individuals during their lifetimes to avoid the imposition of estate taxes at their deaths. Inter-vivos transfers obviously precluded the decedent's estate from being entitled to a "step-up" in basis adjustment under Section 1014 of the Internal Revenue Code of 1986, as amended (the "Code"). Because the estate tax rates were significantly greater than the income tax rates, the avoidance of estate taxes (typically to the exclusion of any potential income tax savings from the "step-up" in basis) was the primary focus of tax-based estate planning for wealthy individuals.

3. By way of example, consider the planning landscape in 2001. The Federal estate and gift tax exemption equivalent was $675,000. The maximum Federal transfer tax (collectively, the estate, gift, and generation-skipping transfer tax) rate was 55%, and the law still provided for a state estate tax Federal credit. Because virtually all of the states had an estate or inheritance tax equal to the credit, the maximum combined Federal and state transfer tax rate was 55%. The combined Federal and state income tax rates were significantly lower than that.

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[1] Portions of these materials were previously published and presented at the 48th Annual Heckerling Institute on Estate Planning (January 2014) and in Turney P. Berry & Paul S. Lee, *Retaining, Obtaining and Sustaining Basis*, 39th Annual Notre Dame Tax & Estate Planning Institute (October 2013). I would like to thank and acknowledge Turney P. Berry of Wyatt, Tarrant & Combs, LLP, Cassady V. Brewer of Georgia State University College of Law, Ellen Harrison of Pillsbury Winthrop Shaw Pittman LLP, and M. Read Moore of McDermott Will & Emery LLP for their significant contribution to these materials.

[2] P.L. 112-240, 126 Stat. 2313, enacted January 2, 2013.

[3] § 1411 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.

[4] P.L. 111–152, 124 Stat. 1029, enacted March 30, 2010.

[5] P.L. 111-148, 124 Stat. 119, enacted on March 23, 2010.

Consider the maximum long-term capital gain and ordinary income tax rates of a highly taxed individual, a New York City taxpayer. At that time, the combined maximum Federal, state, and local income tax rate for long-term capital gains was approximately 30% and for ordinary income, less than 50%.[6] As a result, the gap between the maximum transfer tax rate and the long-term capital gain tax rate for a New York City taxpayer was approximately 25%. In other words, for high income, high-net-worth individuals in NYC, there was a 25% tax rate savings by avoiding the transfer tax and foregoing a "step-up" in basis. Because this gap was so large (and larger in other states), estate planning recommendations often came down to the following steps, ideas and truths:

a. Typically, as the first step in the estate planning process, make an inter-vivos taxable gift using the $675,000 exemption equivalent, thereby removing all future appreciation out of the estate tax base.

b. Use the exemption equivalent gift as a foundation to aggressively transfer assets out of the estate during lifetime (for example, a "seed" gift to an intentionally defective grantor trust ("IDGT")—a trust that is a grantor trust[7] for income tax purposes but the assets of which would not be includible in the estate of the grantor—to support the promissory note issued an installment sale to the IDGT).[8]

c. Draft the trusts and other estate planning structures to avoid estate tax inclusion for as many generations as possible (for example, leveraging the generation-skipping transfer ("GST") tax exemption by applying it to the seed gift to the IDGT and establishing the trust in a jurisdiction that has abolished the rule against perpetuities).

d. Forego the "step-up" in basis adjustment at death on the assets that have been transferred during lifetime, because the transfer tax savings were typically much greater than any potential income tax savings that might result from the basis adjustment at death.

e. Know that the income tax consequences of the various estate planning techniques were appropriately secondary to avoiding the transfer tax.

f. Know that the state of residence of the decedent and the decedent's beneficiaries did not significantly affect the foregoing recommendations or ideas because the large gap between the transfer tax and the income tax existing consistently across all of the states. As a result, there was an enormous amount of consistency in the estate planning recommendations across the U.S., where the only differentiating factor was the size of the gross estate. In other words, putting aside local law distinctions like community vs. separate property, almost all $20 million dollar estates had essentially the same estate plan (using the same techniques in similar proportions).

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

[7] §§ 671-679.

[8] *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 (2006).

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

B. The New Tax Landscape

1. Generally

a. The new tax landscape for estate planners in 2013 and beyond is transformed by increased income tax rates, and the falling transfer tax liability, at both the Federal and state level. On the Federal side, the income and transfer tax provisions that became effective January 1, 2013, were enacted as part of ATRA, PPACA and HCERA (the Medicare tax). In the states, many states increased their income tax rates,[9] and a number of states continued the trend of repealing their state death tax (estate and inheritance tax).[10]

b. A complete discussion of all of the provisions of the Federal laws and the state laws is beyond the discussion of this outline. So, I have limited the discussion to the most salient provision

2. Pertinent Provisions of ATRA

a. Federal Transfer Tax Landscape

(1) Summary of the Pertinent Income Tax Provisions

(a) The top estate, gift, and GST tax rate is 40%.[11]

(b) The basic applicable exclusion amount[12] (sometimes referred to as the "Applicable Exclusion Amount" or the "Applicable Exclusion") for each individual is $5 million,[13] indexed for inflation after 2011[14] ($5.34 million for 2014).[15]

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[9] For example, the California enactment in 2012 of the Temporary Taxes to Fund Education, commonly known as Proposition 30 that raised the highest marginal income tax bracket to 13.3%.

[10] For example, on July 23, 2013, North Carolina repealed its estate tax (effective date of January 1, 2013), The North Carolina Tax Simplification and Reduction Act, HB 998, and on May 8, 2013, Indiana repealed its inheritance tax (effective date of January 1, 2013), Indiana House Enrolled Act No. 1001.

[11] § 2001(c) (for transfers above $1 million) and § 2641(a)(1).

[12] § 2010(c)(2); Temp. Treas. Reg. § 20.2010-1T(d)(2).

[13] § 2010(c)(3)(A); Temp. Treas. Reg. § 20.2010-1T(d)(3)(i).

[14] § 2010(c)(3)(B); Temp. Treas. Reg. § 20.2010-1T(d)(3)(ii).

[15] Rev. Proc. 2013-35, 2013-47 I.R.B. 537, Section 3.32.

(c) Reunification of the estate, gift and GST tax system (providing a GST exemption amount equal to the basic Applicable Exclusion Amount under § 2010(c) of the Code).[16]

(d) Permanent instatement of the "portability" of a deceased spouse's unused exclusion amount ("DSUE Amount").[17]

(e) Repeal of the "sunset" provision with respect the foregoing transfer tax provisions.[18]

(2) Applicable Exclusion Amount

(a) As mentioned above, ATRA "permanently" provides for a cost-of-living increase to the Applicable Exclusion Amount. When one considers that the inflation adjustment cannot be adjusted downward even in deflationary environments,[19] it becomes clear that the Applicable Exclusion Amount can grow to a very large number.

(b) The following table is a forecast of the resulting Applicable Exclusion Amount 10 and 20 years from now:[20]

FORECASTED APPLICABLE EXCLUSION AMOUNT ($ MILLION)			
	2014	2023	2033
Low Inflation	---	$5.66	$6.37
Median Inflation	$5.34	$6.58	$8.95
High Inflation	---	$8.18	$14.60

b. Pertinent Income Tax Provisions

(1) Increase of the highest Federal ordinary income tax bracket to 39.6%.[21]

[16] § 2631(c).

[17] § 2010(c)(4). Enacted as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312, 124 Stat. 3296 ("TRA 2010"). § 101(a)(2) of ATRA struck the "sunset" provisions of TRA 2010 by striking § 304 of TRA 2010.

[18] § 101(a)(1) of ATRA provides for a repeal of the "sunset" provision in the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, 115 Stat. 38, ("EGTRRA"). The "sunset" provision of EGTRRA is contained in § 901 ("All provisions of, and amendments made by, this Act [EGTRRA] shall not apply… to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010," and the "Internal Revenue Code of 1986 … shall be applied and administered to years, estates, gifts, and transfers … as if the provisions and amendments described [in EGTRRA] had never been enacted.").

[19] Temp. Reg. § 20.2010-1T(d)(3)(ii).

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

(2) Increase of the highest Federal long-term capital gain bracket to 20%.[22]

(3) Increase of the highest Federal "qualified dividend income" rate to 20%.[23]

3. The 3.8% Medicare Tax on Net Investment Income

a. A full and complete discussion of the 3.8% Medicare tax is beyond the scope of this outline but a general understanding is important. Fortunately, there are a number of better resources for that discussion.[24]

b. For taxable years starting in 2013, Section 1411 of the Code imposes a 3.8% Medicare tax on "net investment income"[25] ("NII") which includes:

(1) "Gross income from interest, dividends, annuities, royalties, and rents,"[26] (passive income), other than such passive income that is "derived in the ordinary course of a trade or business"[27] that is not a "Passive Activity or Trading Company" (as defined below);

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

(a) A trade or business that is "a passive activity (within the meaning of section 469) with respect to the taxpayer;"[28] or

(b) A trade or business that trades in "financial instruments or commodities (as defined in section 475(e)(2))."[29]

(3) Gain "attributable to the disposition of property other than property held in a trade or business not described"[30] as a Passive Activity or Trading Company; or

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[21] § 1 (for individuals with taxable income over $406,750 and married individuals filing jointly with taxable income over $457,600). *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 537, Section 3.01.

[22] § 1(h)(1)(D) (for individuals with taxable income over $406,750, married individuals filing joint returns with taxable income over $457,600, and for estates and trusts with taxable income over $12,150). *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 537, Section 3.01.

[23] § 1(h)(11) (allowing such income to be considered "net capital gain").

[24] *See* Richard L. Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1 & Part 2*, Tax Notes, Aug. 12. 2013, p. 683 and Aug. 19, 2013, p. 785, and Blattmachr, Gans and Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts*, 40 Est. Plan. 3 (Apr. 2013).

[25] § 1411(c).

[26] § 1411(c)(1)(A).

[27] *Id.*

[28] § 1411(c)(2)(A).

[29] § 1411(c)(2)(B).

[30] § 1411(c)(2)(C).

(4) Gross income from the investment of working capital.[31]

c. In arriving at NII, the Code provides for "deductions . . . which are properly allocable to such gross income or net gain."[32]

d. For individuals, the 3.8% Medicare tax is imposed against the lesser of:[33]

(1) NII; or

(2) The excess of:

(a) "modified adjusted gross income for such taxable year"[34] ("MAGI"), over

(b) The "threshold amount"[35] ($200,000 for individual taxpayers, $250,000 for joint taxpayers, and $125,000 for married taxpayers filing separately).[36]

e. For estates and trusts, the 3.8% Medicare tax is imposed against the lesser of:[37]

(1) The undistributed NII for the taxable year, over

(2) The excess of:

(a) Adjusted gross income (as defined in § 67(e) of the Code),[38] over

(b) "[T]he dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year"[39] ($12,150 of taxable income for 2014).[40]

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[31] § 1411(c)(3), referencing § 469(e)(1)(B), which provides "any income, gain, or loss which is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business." *See* Prop. Reg. § 1.1411-6(a).

[32] § 1411(c)(1)(B).

[33] § 1411(a)(1)(A).

[34] § 1411(a)(1)(B)(i). Modified adjusted gross income is "adjusted gross income" as adjusted for certain foreign earned income. § 1411(d).

[35] § 1411(a)(1)(B)(i).

[36] § 1411(b).

[37] § 1411(a)(2).

[38] § 1411(a)(2)(B)(i).

[39] § 1411(a)(2)(B)(ii).

[40] *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 537, Section 3.01.

f. It is notable that the threshold amount for individuals does not increase with cost-of-living adjustments, but the taxable income amount threshold for trusts and estates does.

g. With respect to a disposition of a partnership interest or S corporation shares, the net gain will be subject to the 3.8% Medicare tax but "only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest."[41]

h. The following are excluded from the definition of NII:

(1) Distributions from "a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A or 457(b),"[42] specifically referring to: [43]

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

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

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

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

(e) A Roth IRA under section 408A of the Code; and

(f) A deferred compensation plan of a State and local government or a tax-exempt organization under section 457(b) of the Code.

(2) Gain or other types of income that generally would not be taxable under the Code, including: [44]

(a) Interest on state and local bonds (municipal bonds) under § 103 of the Code.

(b) Deferred gain under the installment method under § 453 of the Code.

(c) Deferred gain pursuant to a like-kind exchange under § 1031 of the Code and an involuntary conversion under § 1033 of the Code.

(d) Gain on the sale of a principal residence under § 121 of the Code.

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[41] § 1411(c)(4)(A).

[42] § 1411(c)(5).

[43] REG-130507-11, Preamble and Proposed Regulations under Section 1411 (December 5, 2012), Fed. Reg. Vol. 77, No. 234, p. 72612-33 (hereinafter, "Preamble to § 1411 Proposed Regulations").

[44] *See* Preamble to § 1411 Proposed Regulations.

i. The application of the Medicare tax to trusts that own closely-held business interests is controversial, and there is considerable uncertainty how a fiduciary that owns interests in a closely-held business can materially participate and thereby avoid the imposition of the tax.

(1) In *Mattie K. Carter Trust v. U.S.*,[45] the court held that in determining material participation for trusts the activities of the trust's fiduciaries, employees, and agents should be considered. The government argued that only the participation of the fiduciary ought to be considered but the court rejected that argument.

(2) Notwithstanding the foregoing, the IRS ruling position is that only the fiduciary's activities are relevant. The IRS reaffirmed this ruling position in TAM 201317010. The ruling explains the IRS rationale as follows:

> The focus on a trustee's activities for purposes of § 469(h) is consistent with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employee's to satisfy the material participation requirement. *See* S. Rep. No. 99-313, at 735 (1986) ("the activities of [employees] . . . are not attributed to the taxpayer."). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An interpretation that renders part of a statute inoperative or superfluous should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).[46]

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

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

[45] 256 F. Supp.2d 536 (N.D. Tex. 2003)

[46] TAM 201317010.

in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.

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

4. Disparity among the States

a. The state estate and inheritance tax (collectively, "state death tax") landscape has dramatically changed since 2001. In 2001, almost every state had an estate and/or inheritance tax that was tied to the then existing Federal state death tax credit.[47] As the law stands today, the Federal state death tax credit has been replaced by a Federal estate tax deduction under § 2058 of the Code, and only 17 states still retain a generally applicable death tax.[48] To complicate matters, even in those states that still retain a death tax, the rates and exemption can vary significantly. For example, Washington's estate tax provides for a top rate of 20% and an exemption of $2 million per person (indexed for inflation starting January 1, 2014 but only for the Seattle-Tacoma-Bremerton metropolitan area). Pennsylvania, on the other hand, provides for an inheritance tax rate of 4.5% for transfers to descendants, with virtually no exemption. When taken in conjunction with the transfer tax provisions of ATRA (both the top Federal tax rate at 40% and the large Applicable Exclusion Amount), the combined Federal and state transfer tax cost to high-net-worth individuals has significantly fallen, when compared to 2001, by way of example.

b. On the income tax side of the coin, each state obviously has its own state and local income tax laws and rates. A number of states have no state and local income tax (Florida, Texas, Nevada, New Hampshire, and Washington) and other states (California, Hawaii, Minnesota, New Jersey, New York, and Oregon) have relatively high income tax rates. When taken in conjunction with the income tax provisions of ATRA and the 3.8% Medicare tax, the combined Federal and state income tax cost to most taxpayers has significantly risen, when compared to 2001, for example.

c. As a result, the new estate planning landscape is characterized by significantly lower transfer tax costs, higher income tax rates, and significant disparity among the states when one compares the two taxes. You will find a summary of the current state income and death tax rates in Appendix A (Summary of State Income and Death Tax Rates) of this outline. As mentioned above, in 2001, for a New York City resident there was a 25% difference between the maximum transfer tax rate and the long-term capital gain tax rate.[49] Today, that difference is approximately 13%. In contrast, consider the tax rates in California. Because

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[47] §§ 531 and 532 of EGTRRA provided for a reduction of and eventual repeal of the Federal estate tax credit for state death taxes under § 2011 of the Code, replacing the foregoing with a deduction under § 2058 of the Code.

[48] Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, and Washington. Iowa and Kentucky have an inheritance tax, but the exemption to lineal heirs is unlimited.

[49] New York has a maximum estate tax rate of 16%, when added to the maximum Federal tax rate of 40% and deducted pursuant to § 2058 of the Code, the combined maximum transfer tax rate is 49.6%, compared to a maximum long-term capital gain tax rate of 36.5% for New York City taxpayers in the alternative minimum tax (20% Federal, 3.8% Medicare tax, 8.82% state, and 3.88% local).

California does not have a state death tax, but currently has the highest combined income tax rate in the U.S., the difference between the transfer tax rate and the long-term capital gain tax rate is less than 3%.[50] Notably, the top combined ordinary and short-term capital gain tax rate in California is greater (approximately, 45% to 53%) than the transfer tax rate.

d. If one considers the "gap" (the difference between the transfer tax and the income tax rates) as a proxy for how aggressively estate planners will consider transferring assets out of the estate during lifetime, then one can see large differences among the states. On one side, there is California, where there is a very small or negative difference, compared to Washington where there is very large gap (approximately 28% difference above the long-term capital gain tax rate).[51]

e. As a result, it is my hypothesis that the consistency that used to exist across the U.S. for similarly situated clients (distinguished only by the size of the potential gross estate) will no longer exist. As a result, one will see large disparities among estate plans based on the state of residence of the client. For example, it can be argued that California residents should be much more passive in their estate plans, choosing more often than not, to simply die with their assets, than Washington residents. This is because the income tax savings from the "step-up" in basis may, in fact, be greater than the transfer tax cost, if any.

C. The New Paradigm in Estate Planning

1. Given how large the Applicable Exclusion Amount will be in the future, it becomes clear that increasingly the focus of estate planning will move away from avoiding the transfer tax, and more focused on the income tax. Much of the estate planning analysis will be about measuring the transfer tax cost against the income tax savings of allowing the assets to be subject to Federal and state transfer taxes.

2. If I were to summarize what the new "paradigm" will be for estate planning in the future, it might look something like this:

a. Estate planning will be more complicated and nuanced than in the past. Estate plans will vary significantly based upon many more variables like:

(1) Time horizon or life expectancy of the client.

(2) Spending or lifestyle of the client, including charitable giving.

(3) Size of the gross estate.

(4) Future return of the assets.

(5) Tax nature of the types of assets (for example, to what extent will a "step-up" in basis benefit the client and the beneficiaries?).

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[50] Combined long-term capital gain tax rate of 37.1% for California taxpayers in the alternative minimum tax (20% Federal, 3.8% Medicare tax, and 13.3% state).

[51] Washington does not have a state income tax.

(6) Expected income tax realization of the assets (for example, when is it likely that the asset will be subject to a taxable disposition?)

(7) State of residence of the client.

(8) State of residence and marginal income tax bracket of the likely beneficiaries.

(9) Expectations about future inflation.

b. Estate planners will seek to use as little of a client's Applicable Exclusion Amount as possible during lifetime because it will represent an ever-growing amount that will be available at death to provide a "step-up" in basis with little or no transfer tax cost. This conclusion assumes that "zeroed-out" estate planning techniques like installment sales to IDGTs and or "zeroed-out" grantor-retained annuity trusts[52] ("GRATs") can effectively accomplish the same amount of wealth transfer as a taxable gift but without using any or a significant portion of a client's Applicable Exclusion Amount. Wealth transfer is not accomplished when a taxpayer makes a gift and uses his or her Applicable Exclusion Amount toward that gift. There is wealth transfer only if and when the asset appreciates (including any appreciation effectively created by valuation discounts). That is essentially the same concept as an installment sale to an IDGT and a GRAT, except that those techniques require appreciation above a certain rate, like the applicable federal rate[53] ("AFR") or the Section 7520 rate.[54]

c. Estate planners will focus more of the tax planning for clients on the income tax, rather than the transfer taxes. In particular, it is likely estate planning will focus on tax basis planning and maximizing the "step-up" in basis at death.

d. Because the "step-up" in basis may come at little or no transfer tax cost, estate planners will seek to force estate tax inclusion in the future.

e. The state of residence of the client and his or her beneficiaries will greatly impact the estate plan. In other words, if a client is domiciled in California, and his or her beneficiaries living in California, then dying with the assets may be the extent of the tax planning. On the other hand, if the beneficiaries live in a state like Texas that has no state income tax, then transferring the assets out of the estate during the lifetime of the client may be warranted. As a result, estate planners will need to ask clients two questions that, in the past, did not significantly matter:

(1) Where are you likely to be domiciled at your death?

(2) When that occurs, where is it likely that your beneficiaries (children and grandchildren) will reside?

[52] Trust that provides the grantor with a "qualified annuity interest" under Treas. Reg. § 25.2702-3(b).

[53] § 1274.

[54] § 7520.

D. Portability and the New Paradigm

1. The newest feature on the estate planning landscape is portability. A full discussion of the planning implications of portability is beyond the scope of this outline and there are resources publicly available that cover the subject in a comprehensive manner.[55] In the context of the "new paradigm" in estate planning discussed above, portability, at least in theory, can provide additional capacity for the surviving spouse's estate to benefit from a "step-up" in basis with little or no transfer tax costs.

2. In traditional by-pass trust planning, upon the death an individual who has a surviving spouse, assets of the estate equal in value to the decedent's unused Applicable Exclusion Amount fund a trust (typically for the benefit of the surviving spouse). The trust is structured to avoid estate tax inclusion at the surviving spouse's estate. The marital deduction portion is funded with any assets in excess of the unused Applicable Exclusion Amount. The by-pass trust avoids estate tax inclusion at the surviving spouse's estate. From an income tax standpoint, however, the assets in the by-pass trust do not receive a "step-up" in basis upon the death of the surviving spouse. Furthermore, while the assets remain in the by-pass trust, any undistributed taxable income above $11,950 of taxable income will be subject to the highest income tax rates at the trust level.[56]

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

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

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[55] *See* Franklin, Law and Karibjanian*, Portability – The Game Changer*, ABA-RPTE Section (January 2013) (http://meetings.abanet.org/webupload/commupload/RP512500/otherlinks_files/TheGameChanger-3-12-13v11.pdf).

[56] *See* Rev. Proc. 2013-15, 2013-5 I.R.B. 444, Section 2.01.

5. In evaluating the income tax savings of portability planning, planners will want to consider that even for very large estates, the surviving spouse has the option of using the DSUE Amount by making a taxable gift to an IDGT. The temporary Treasury Regulations make clear that the DSUE Amount is applied against a surviving spouse's taxable gift first before reducing the surviving spouse's Applicable Exclusion Amount (referred to as the basic exclusion amount).[57] The IDGT would provide the same estate tax benefits as the by-pass trust would have, but importantly the assets would be taxed to the surviving spouse as a grantor trust thus allowing the trust assets to appreciate out of the surviving spouse's estate without being burdened by income taxes.[58] If the assets appreciate, then this essentially solves the problem of the DSUE Amount being frozen in value. Moreover, if the IDGT provides for a power to exchange assets of equivalent value with the surviving spouse,[59] the surviving spouse can exchange high basis assets for low basis assets of the IDGT prior to death and essentially effectuate a "step-up" in basis for the assets in the IDGT.[60] The ability to swap or exchange assets with an IDGT is discussed in more detail below.

6. Portability planning is slightly less appealing to couples in community property states because, as discussed below, all community property gets a "step-up" in basis on the first spouse's death. Thus, the need for additional transfer tax exclusion in order to benefit from a subsequent "step-up" in basis is less crucial. This is not true, however, for assets that are depreciable (commercial real property) or depletable (mineral interests). As discussed below, these types of assets will receive a "step-up" in basis but over time, the basis of the asset will be reduced by the ongoing depreciation deductions. As such, even in community property states, if there are significant depreciable or depletable assets, portability should be considered.

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

A. Generally

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

2. Although a "step-up" in basis is great in theory, no tax will be saved if the asset is at a loss at the time of death resulting in a "step-down" in basis, the asset has significant basis in comparison to its fair market value at the time of death, or the asset will not benefit at all because it is considered income in respect of a decedent[61] (IRD). Furthermore, even if the assets

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[57] Treas. Reg. § 25.2505-2T(d).

[58] *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[59] § 675(4)(C).

[60] Rev. Rul. 85-13, 1985-1 C.B. 184 and PLR 9535026.

[61] § 691.

will benefit from a significant "step-up" in basis, the only way to capture the income tax benefits of the basis adjustment is to sell the asset in a taxable disposition. Many assets, like family-owned businesses, may never be sold or may be sold so far in the future that the benefit of a "step-up" is attenuated. In addition, even if the asset will be sold, there may be a significant time between the date of death of the decedent when the basis adjustment occurs and the taxable disposition, so some consideration should be given to quantifying the cost of the deferral of the tax savings. Finally, the nature of the asset may be such that even if the asset will not be sold in a taxable disposition, it may confer economic benefit to the beneficiaries. For example, if the asset that receives a "step-up" in basis and the asset is either depreciable or depletable under the Code,[62] the deductions that arise do result in tax benefits to the owners of that asset. In addition, an increase in the tax basis of an interest in a partnership or in S corporation shares may not provide immediate tax benefits, but they do allow additional capacity of the partner or shareholder to receive tax free distributions from the entity.[63] These concepts and how certain assets benefit or don't benefit from the basis adjustment at death are discussed in more detail below.

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

a. By way of example, consider a couple with a relatively large estate, $20 million. As mentioned above, any number of variables will affect whether and to what extent this couple will have an estate tax problem. It would be impossible to explore each of the variables separately and in detail, but let's explore a few important variables: decedent's state of domicile, time horizon, and spending. Assume for purposes of this exercise:

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

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

(3) There is no significant time difference between the deaths of each of them (thereby simplifying the issue of how by-pass/credit shelter trust planning[64] or electing portability under § 2010(c)(5)(A) of the Code would change the overall tax picture).

b. The variables are:

(1) Domicile in California or New York

(2) Time horizon (date of death of the surviving spouse) of 10 or 20 years.

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

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[62] *See e.g.*, § 1016(a)(2).

[63] *See e.g.,* §§ 731(a)(1) and 1368(b).

[64] Generally referring to a trust that is created upon the first spouse's death, which is not subject to Federal estate tax by virtue of the deceased spouse's Applicable Exclusion Amount and which is generally created for the benefit of the remainder of the surviving spouse's lifetime, but is not subject to Federal estate tax in the surviving spouse's estate.

c. The following table shows our forecast of the probabilities of a Federal estate tax liability (a gross estate greater than the joint Applicable Exclusion Amounts), if the couple is domiciled in California:[65]

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

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

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

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

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

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

[65] We are relying upon Bernstein Global Wealth Management's proprietary analytical tool that marries the benefits of stochastic modeling with our structural model of the capital markets. In each scenario Bernstein simulated 10,000 market scenarios or forecasts for the next 20 years, based initially upon the current state of the capital markets. Bernstein's proprietary capital markets engine and wealth forecasting model uses proprietary research and historical data to create a wide range of possible market returns for many asset classes over the coming decades, following many different paths of return. The model takes into account the linkages within and among different asset classes in the capital markets and incorporates an appropriate level of unpredictability or randomness for each asset class.

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

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

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

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

h. What then might estate planners do with this type of data, in deciding what to day from a planning standpoint today? Let's assume we are dealing with a $20 million couple, spending 3%, and with a joint life expectancy of at least 10 years but likely not 20. Well, based on the foregoing tables, although the probabilities of an estate tax liability are high, the average "effective" death tax cost is 16% (California) and 24% (NYC). Whether that liability is too high or too low depends, in large part, on the nature of the types of assets that are likely to be in the estate at date of death.

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

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

C. Community Property Considerations

1. Given the central role the "step-up" in basis has in estate planning now, community property states have a significant advantage over separate property states because both the decedent's and the surviving spouse's on1-half interest in community property will receive a basis adjustment to fair market value under § 1014(b)(6) of the Code. Because the unlimited marital deduction under § 2056 of the Code essentially gives couples the ability to have no transfer taxes on the first spouse's death, this "step-up" in basis provides an immediate income tax savings for the benefit of the surviving spouse (rather than the subsequent beneficiaries).

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

a. During the lifetimes of both spouses, limit inter-vivos transfers and maximize value of the assets in order to benefit the most from the basis adjustment under Section 1014(b)(6) of the Code.

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

3. Notably, with the U.S. Supreme Court's declaration that § 3 of the Defense of Marriage Act[66] ("DOMA") is unconstitutional, pursuant to its decision in *U.S. v. Windsor*,[67] and the issuance of Revenue Ruling 2013-17,[68] the tax planning ramifications are far reaching for clients in states like California where community property and same-sex marriage laws exist.[69]

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

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[66] 1 U.S.C. § 7. § 3 of DOMA defined marriage and spouse as excluding same-sex partners.

[67] 570 U.S. ____ (2013), 133 S. Ct. 2675 (2013).

[68] Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

[69] *Hollingsworth v. Perry*, 790 F.Supp.2d 1149 (N.D. Cal. 2010), *aff'd*, 591 F.3d 114 (9th Cir. 2010 & 2012), *aff'd*, No. 12-144 (U.S. 6/26/13)

III. SECTION 1014 AND THE TAX NATURE OF CERTAIN ASSETS

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

a. Generally, under Section 1014(a)(1) of the Code, the "basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent" is the "fair market value of the property at the date of the decedent's death."[70] The foregoing general rule is often referred to as the "step-up" in basis at death, under the assumption that assets generally appreciate in value. However, many assets depreciate in value, and this general rule will mean a loss of tax basis to fair market value at date of death (a "step-down" in basis). For purposes of this outline, I refer to the general rule of Section 1014(a)(1) as a "step-up" in basis, whether the asset is appreciated or at a loss at the time of the decedent's death.

b. The Code goes on to say that if the executor of the estate elects an alternate valuation date under Section 2032 of the Code or special use valuation under Section 2032A of the Code, then the basis is equal to the value prescribe under those Code sections.[71]

c. If land or some portion of such land that is subject to a qualified conservation easement is excluded from the estate tax under Section 2031(c) of the Code, then "to the extent of the applicability of the exclusion," the basis will be the "basis in the hands of the decedent"[72] ("carryover basis").[73]

d. If appreciated property (determined on date of the gift) was gifted to the decedent within 1-year prior to the date of death, and the decedent transfers the property back to the original donor of such property (or the spouse of the donor), the property will not receive a "step-up" in basis and it will have the basis in the hands of the decedent before the date of death.[74] This rule does not apply if the property passes to the issue of the original donor, and it is unclear whether this rule applies if the property is placed in trust where the original donor or donor's spouse is a potential beneficiary.

B. Community Property and Elective/Consensual Community Property

1. As mentioned above, the Code provides a special rule for community property. Section 1014(b)(6) of the Code provides that "property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate"[75] shall be deemed to have been acquired from or to have passed from the decedent.

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[70] § 1014(a)(1).

[71] §§ 1014(a)(2) and (3).

[72] § 1014(a)(4).

[73] § 1015.

[74] § 1014(e).

[75] § 1014(b)(6).

2. There are currently nine community property states in the U.S.: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. There are two states that are separate property states but they allow couples to convert or elect to treat their property as community property: Alaska[76] and Tennessee.[77] Generally, these elective or "consensual community property" laws allow resident and nonresident couples to classify property as community property by transferring the property to a qualifying trust. Generally, for nonresidents, a qualifying trust requires at least one trustee who is a resident of the state or a company authorized to act as a fiduciary of such state, and specific language declaring the trust asset as community property.

3. Clearly, for residents of separate property states, taking advantage of the "consensual community property" laws of another state has the potential for a basis adjustment under Section 1014(b)(6) of the Code. There has been no direct ruling on whether that would be the case under the laws of Alaska or Tennessee. However, a number of commentators have argued that assets in such "consensual community property" arrangements would, indeed, receive a full "step-up" in basis under Section 1014(b)(6) of the Code.[78] A professional fiduciary must be designated in Alaska or Tennessee in order to invoke the respective statutes and the administrative expense ought to be weighed against the potential benefit, taking into consideration the uncertainty.

C. Establishing Community Property and Maintaining the Character

1. Given how valuable the full "step-up" in basis under Section 1014(b)(6) of the Code can be for community property, practitioners will need to pay special attention to methods of transmuting separate property to community property and maintaining the community property even if the couple moves to a separate property state. Married couples who move from a separate property state and establish residence in a community property state can typically transmute their separate property to community property by way of agreement.[79] By way of example, California provides "married person may be agreement or transfer, with or without consideration… transmute separate property of either spouse to community property."[80] As long as the couple has the intent to remain permanently in the community property state, the transmutation could occur immediately upon establishing residence in the state. In other words, there is no time requirement after establishing residency when transmutation would be considered valid.

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

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[76] Alaska Stat. 34.77.010 et al. (Alaska Community Property Act).

[77] Tenn. Code Ann. § 35-17-101 et al. (Tennessee Community Property Trust Act of 2010).

[78] Jonathan G. Blattmachr, Howard M. Zaritsky and Mark L. Ascher. *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Probate and Tr. J. 615 (Winter 1999).

[79] Simply moving to a community property state will typically not automatically cause separate property to be considered community property.

[80] Cal. Fam. Code § 850.

tenants in common, notwithstanding the fact that the source of the funds is community property. Furthermore, if one spouse transfers assets to another spouse outright (as often happens in the estate planning process to "equalize" the estates of the spouses who are now living in a separate property state), the property is no longer considered community property. Generally income from community property and reinvestments of such income will retain its community property character. Money earned while domiciled in a separate property state will obviously be considered separate property. It is quite easy for commingling of funds to occur if, for example, an asset is bought with both community and separate property. Tracing of the funds and the income from such funds will be required from that point forward. As such, practitioners in separate property states should pay special attention to those clients who move from community property states and may want to consider ways to ensure and make clear how such property will continue to be held and reinvested.

3. Fourteen separate property states (Alaska, Arkansas, Colorado, Florida, Hawaii, Kentucky, Michigan, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming) have enacted the Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA"). UDCPRDA provides that property that was originally community property will retain its character as such for testamentary purposes. The UDCPRDA is limited in scope,[81] and is not a tax statute. It is not clear whether decedents with surviving spouses who live in a state that has enacted the UDCPRDA are in a better position to claim the "step-up" in basis under Section 1014(b)(6) of the Code, than those decedents who do not.

D. Joint Revocable Trusts and the "JEST"

1. Following in the line a of number of number of rulings,[82] a planning technique referred to as the "Joint Exempt Step-Up Trust" ("JEST") has arisen that seeks to give married couples residing in non-community property states some of the same "step-up" in basis enjoyed by couples who pass away with community property under Section 1014(b)(6) of the Code. The attorneys who developed this technique have recently published the details of the JEST, including the numerous tax, creditor protection, and other legal issues surrounding the technique.[83]

2. The basic structure of the JEST is:

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

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[81] It is limited to limited to real property, located in the enacting state, and personal property of a person domiciled in the enacting state. UDCPRDA

[82] PLRs 200102021, 200210051, 200604028, 200413011, 200403094 and TAM 9308002

[83] Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1*, 40 Est. Plan. 3 (Oct. 2013), Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 2*, 40 Est. Plan. ___ (Nov. 2013), and Gassman, Ellwanger & Hohnadell, *It's Just a JEST, the Joint Exempt Step-Up Trust*, Steve Leimberg's Estate Planning Email Newsletter-Archive Message #2086 (4/3/13).

b. Upon the first death, all assets are includible in the estate of the first to die.

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

d. If the first dying spouse's share is less than his or her Available Exemption Amount, then the surviving spouse's share will be used to fund a "Credit Shelter Trust B" with assets equal to the excess exemption. According to the authors of this technique, the assets of the Credit Shelter Trust B will avoid estate taxation at the surviving spouse's death, notwithstanding that the surviving spouse originally contributed the assets to the JEST and had the power to terminate the trust and reclaim the assets. The authors provide that in order to further assure a step-up in basis on the assets in the Credit Shelter Trust B, it is best that the surviving spouse is not a beneficiary of Credit Shelter Trust B or perhaps to only be a beneficiary that may be added by an independent trust protector in the future.

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

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

E. Section 2038 Estate Marital Trusts

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

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

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

c. The Grantor Spouse retains the power, in a non-fiduciary capacity, to reacquire or "swap" the trust corpus by substituting other property of an equivalent value.

2. The trust does not provide for distribution of all income annually[84] or for the conversion of unproductive property[85] as would be required for general power of appointment marital trusts and QTIP Trusts. However, the trust should qualify for the gift tax marital deduction because the trust funds are payable only to the Beneficiary Spouse's estate, and thus the spouse's interest is not a nondeductible terminable interest under Section 2523(b).[86]

3. The contribution of assets to the trust should be a completed gift notwithstanding the Grantor Spouse's right to change the manner or time of enjoyment of the assets because the only beneficiary of the trust is the Beneficiary Spouse or the estate of the Beneficiary Spouse.[87]

4. During the lifetime of the Beneficiary Spouse, the trust will be treated as a grantor trust for income tax purposes with respect to the Grantor Spouse under Section 677(a) of the Code. It provides, in pertinent part, the "grantor shall be treated as the owner of any portion of a trust… whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor … may be distributed to … the grantor's spouse"[88] or "held or accumulated for future distribution to … the grantor's spouse."[89] Because the Beneficiary Spouse and his or her estate is the sole beneficiary of the lifetime and the remainder interests, grantor trust treatment should be as to all of the assets in the trust and as to both income and principal.[90] Thus, no portion of the trust's income should be taxable as a non-grantor trust. However, in order to ensure grantor trust status as to all of the assets and tax items of the trust, practitioners might consider having the Grantor Spouse retaining the power, in a non-fiduciary capacity, to reacquire or "swap" the trust corpus by substituting other property of an equivalent value.[91]

5. If the Beneficiary Spouse dies first, the trust assets are payable to his or her estate and thus are includible in the gross estate under Section 2031 of the Code and entitled to a "step-up" in basis.

6. If the Grantor Spouse dies first, the trust assets will be includible in the gross estate under Section 2038 of the Code. It provides, the gross estate will include the value of all property "[t]o the extent of any interest therein of which the decedent has at any time made a transfer … by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where

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[84] *See* §§ 2056(b)(5), 2056(b)(7)(B)(ii)(I), Treas. Reg. § 20.2056(b)-7(d)(2), Rev. Rul. 72-333, 1972-2 C.B. 530, and Rev. Rul. 68-554, 1968-2 C.B. 412.

[85] *See* Treas. Reg. §§ 20.2056(b)-5(f)(4) and 20.2056(b)-5(f)(5).

[86] *See* Treas. Reg. §§ 25.2523(a)-1(b)(3), 25.2523(b)-1 and 20.2056(c)-2(b)(1)(iii). See also

[87] *See* Treas. Reg. § 25.2511-2(d).

[88] § 677(a)(1).

[89] § 677(a)(2).

[90] See Treas. Reg. § 1.677(a)-1(g).

[91] § 675(4)(C) and Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

any such power is relinquished during the 3 year period ending on the date of the decedent's death."[92]

F. The Nature of Particular Assets

1. Generally

a. Understanding how and to what extent assets will benefit from a "step-up" in basis is critical to the estate planning process today. Obviously, certain assets like highly-appreciated assets will benefit more from the "step-up" in basis at death than cash (which has a basis equal to its face value which is equal to its fair market value) or property at a loss (a "step-down" in basis). Moreover, appreciated assets like gold that are considered "collectibles"[93] under the Code, benefit more from a step-up in basis than other appreciated capital assets because the Federal long-term capital gain tax rate for collectibles is 28%, rather than 20%.

b. If one were to list asset categories or types, starting with those that benefit the most from the "step-up" in basis and ending with those that benefit the least (or actually suffer a "step-down" in basis), it might look as follows:

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

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

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

(4) Low basis stock or other capital asset;

(5) Roth IRA assets;

(6) High basis stock;

(7) Cash;

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

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

(10) Variable annuities; and

(11) Traditional IRA and qualified plan assets.

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

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[92] § 2038(a)(1).

[93] § 1(h)(4).

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

a. Generally

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

(2) Patents, copyrights, and trademarks are common assets, but intangible rights might also include the right of publicity, defined loosely as the right of an individual to have a monopoly on his or her own name, likeness, attributes, etc. In the case of well-known artists, actors, and celebrities, this right of publicity can be quite valuable. Some states, like New York, do not recognize a postmortem right to publicity,[94] while approximately 19 states have specifically codified the postmortem right to publicity. Notably, California[95] has codified the postmortem right to publicity, which lasts for a term of 70 years after the death of the personality. Further, the California statute specifically provides that such rights are freely transferable during lifetime or at death.

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

b. Copyrights

(1) Under U.S. law, copyright protection extends to "original words of authorship fixed in any tangible medium of expression," which includes: "(1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works."[96] The courts have ruled that computer software constitutes protected literary works.[97]

(2) Knowing the duration of an existing copyright is critical to understanding what value a copyright may have today and what value a copyright may have in the future.

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[94] *See, Milton H. Greene Archives Inc. v. Marilyn Monroe LLC*, No. 08-056471 (9th Cir. 8/30/12), *aff'g* 568 F. Supp. 2d 1152 (C.D. Cal. 2008). *See* http://rightofpublicity.com for a good discussion of statues, cases, and current controversies, maintained by Jonathan Faber of the Indiana University McKinney School of Law.

[95] Ca. Civ. Code § 3344.

[96] 17 U.S.C. § 102(a)(1)-(8).

[97] *See*, *e.g.*, *Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1243 (3rd Cir. 1983).

(a) For works copyrighted on or after January 1, 1978, a copyright's duration is based upon the life of the author plus 70 years.[98]

(b) For works copyrighted prior to January 1, 1978, a copyright's duration was 28 years, with the author (and his or her estate) having the right to renew and extend the term for another 67 years (for a total of 95 years).[99]

(3) For works copyrighted on or after January 1, 1978, the author (or the author's surviving spouse or descendants if the author is deceased) has a right to terminate any transfer or assignment of copyright by the author 35 years after the transfer or assignment.[100] These termination rights apply "in the case of any work other than a work made for hire, the exclusive or nonexclusive grant of a transfer or license of copyright or of any right under a copyright, executed by the author on or after January 1, 1978, otherwise than by will."[101] Because only the author has the right of termination during his or her lifetime, even if a gift is made of the copyright, the author's continued right of termination calls into question how the copyright will be valued.

(4) Payments to the creator of a copyright on a non-exclusive license give rise to royalty income, taxable as ordinary income.[102] An exclusive license (use of substantially all of the seller's rights in a given medium) is treated as a sale or exchange. When the creator is the seller, it is deemed to be a sale of an asset that is not a capital asset,[103] so it is taxed at ordinary rates. By contrast, if the seller is not the creator, capital asset treatment under Section 1221 of the Code is available if such seller is not a dealer.[104] Notwithstanding the foregoing, if the creator/author of the copyright, gifts the asset (carryover basis transaction), a sale or exchange by the donee is not afforded capital treatment either.[105] A gift for estate planning purposes, therefore, may have the unintended effect of prolonging ordinary income treatment after the death of the author/creator of the copyright.

(5) In contrast, upon the death of the author/creator who still owns the asset at death, the copyright is entitled to a "step-up" in basis to full fair market value under Section 1014 of the Code and the asset is transformed into a long-term capital gain asset. Because the basis of the copyright included in the creator's estate is no longer tied to that of the creator, the asset no longer falls within the exclusion from capital asset treatment under Section 1221(a)(3) and, thus, are capital assets in the hands of the creator's beneficiaries. The copyright

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[98] 17 U.S.C. § 302(a).

[99] 17 U.S.C. § 304.

[100] 17 U.S.C. § 203(a).

[101] *Id.*

[102] § 61(a)(6). *See also* Treas. Reg. § 1.61-8. Rev. Proc. 2004-34, 2004-22 I.R.B. 964, allows certain taxpayers to defer to the next taxable year, certain payments advance royalty payments.

[103] § 1221(a)(3). § 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have § 1221(a)(3) not apply to a sale or exchange.

[104] It could also be afforded § 1231 treatment (asset primarily held for sale to customers in the ordinary course of a trade or business).

[105] § 1221(a)(3)(C).

is deemed to immediately have a long-term holding period even if it is sold within 1 year after the decedent's death.[106]

c. Patents

(1) Individuals who patent qualifying inventions are granted the "right to exclude others from making, using, offering for sale, or selling"[107] such invention for a specified term. The term for a utility or plant patent is 20 years, beginning on the earlier of the date on which the application for the patent was filed.[108] The term for a design patent is 14 years from the date of grant.[109]

(2) Similar to the taxation of copyrights, payments received for a transaction that is not considered a sale or exchange or payments received for a license will be considered royalty income, taxable as ordinary income.[110]

(3) A sale or exchange of a patent that does not qualify under Section 1235 of the Code (discussed below), may qualify for capital gain treatment because the Treasury regulations specifically provide that a patent or invention are not considered "similar property"[111] to a copyright, which is excluded from capital gain treatment. However, for the sale of a patent to qualify for capital gain treatment under Section 1221 of the Code, the individual generally must be considered a non-professional inventor (otherwise the patent would be considered stock in trade or inventory in the hands of a professional inventor). Capital gain treatment under Section 1231 of the Code is possible but only if the patent is considered to have been "used in a trade or business."[112] Often, however, patents held by individuals will not qualify as such. By consequence, generally, for individuals selling or exchanging a patent, the avenue for capital gain treatment is under Section 1235 of the Code.

(4) Like the tax treatment of the creator of a copyright, if the creator dies with a patent, the asset is entitled to a "step-up" in basis to full fair market value under Section 1014 of the Code and the asset is transformed into a long-term capital gain asset.

(5) Section 1235 Transactions

(a) Section 1235 of the Code provides that a "transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or

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[106] § 1223(9).

[107] 35 U.S.C. § 154(a)(1).

[108] 35 U.S.C. § 154(a)(2).

[109] 35 U.S.C. § 173.

[110] § 61(a)(6). *See also* Treas. Reg. § 1.61-8.

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

[112] § 1231(a)(3)(A)(i). The holding period is deemed to start when the patent is reduced to practice. *Kuzmick v. Commissioner*, 11 T.C. 288 (1948).

an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year."[113]

(b) Only an individual may qualify as a holder, regardless of whether he or she is in the business of making inventions or in the business of buying and selling patents.[114] Specifically, a qualified "holder" includes (i) the creator of the patent,[115] or (ii) "any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent,"[116] provided that in such instance, the individual is not an employer of the creator or related to the creator.[117] As such, a trust, estate, or corporation will not qualify as a holder under Section 1235 of the Code, although a transfer to a grantor trust would not likely disqualify a subsequent sale or exchange to capital gain treatment.[118] An entity taxable as a partnership does not qualify as a holder, but each individual in the partnership may qualify separately as such.[119]

(c) A sale or exchange by a qualified holder to a "related person" will not qualify for capital-gain treatment under Section 1235 of the Code.[120] A "related person" is generally defined by reference to Section 267(b) of the Code and includes (i) the holder's spouse, ancestors, and lineal descendants (but not siblings);[121] (ii) a fiduciary of any trust of which the holder is the grantor; (iii) any corporation, partnership, or other entity in which the holder (and other related persons) own 25% or more of the ownership interests.[122]

(d) Because of the foregoing limitations of who can qualify as a holder and the related person limitations on who can be the transferee, many estate planning techniques involving patents are limited if capital gain treatment is to be retained.

(e) If a qualified holder sells his or her interest in a patent under Section 1235 of the Code and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as income in respect of a decedent.[123]

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[113] § 1235(a).

[114] § 1235(a)(2) and Treas. Reg. § 1.1235-2(d)(3).

[115] § 1235(b)(1).

[116] § 1235(b)(2).

[117] § 1235(b)(2)(A)-(B).

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

[119] Treas. Reg. § 1.1235-2(d)(2). *See also*, PLRs 200135015, 200219017, 200219019, 200219020, 200219021, 200219026, 200506008, 200506009, and 200506019.

[120] § 1235(d).

[121] § 1235(d)(2)

[122] § 1235(d)(1).

[123] § 691 and Treas. Reg. § 1.691(a)(3).

d. Artwork

(1) The taxation of artwork in the hands of the artist is the same as it would be for the creator of a copyright, as discussed above. Generally, all payments pursuant to a license and a taxable sale or exchange of the artwork give rise to ordinary income.[124] A third-party collector or investor in the artwork might qualify for capital gain treatment or Section 1231 treatment, as long as the property is not held out for sale in the ordinary course of a trade or business (inventory).[125] Similarly, capital gain treatment is not available to a donee of the artist because the donee's basis is determined by reference to the artist's basis.[126]

(2) Artwork in the hands of a collector or investor (third-party other than the creator or a donee of the creator) is considered a collectible under the Code and would be subject to the 28% long-term capital gain tax, rather than 20%.[127] Under the Code, a "collectible" is any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other tangible personal property designated by the IRS as such.[128]

(3) As with copyrights and patents, the basis of property in the hands of a person acquiring property from a deceased artist is the fair market value of the property at the date of the artist's death or on the alternate valuation date, if so elected.[129] The artwork in the hands of the estate or the artist's beneficiaries becomes a capital asset, qualifying for long-term capital gain treatment.[130]

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

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

b. The following example illustrate how this "negative basis" problem can arise and how costly a taxable event would be from an income tax standpoint:

(1) Taxpayer buys an office building in 1983 for $10,000,000 (assume for purposes of this example, the entire purchase price is properly allocated to the office building, which is depreciable). Over the next 30 years, the property appreciates in value, the

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[124] §§ 1221(a)(3) and 61(a)(6). § 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have § 1221(a)(3) not apply to a sale or exchange.

[125] § 1221(a)(1).

[126] §§ 1221(a)(5)(B) and 1015.

[127] § 1(h)(4).

[128] §§ 1(h)(5)(A) and 408(m)(2).

[129] § 1014(a).

[130] *See* §§ 1221(a)(3) and 1223(9).

taxpayer fully depreciates the original basis of $10 million in the building to zero,[131] borrows against the property, and takes the loaned funds tax free. As a result in 2013, the office building is now worth $20 million, has zero adjusted tax basis, and has a mortgage on the building of $15 million ($5 million of net equity in the property).

(2) Note, because the property was placed in service in 1983, an accelerated method of depreciation was allowable on the property.[132] As such, a taxable sale of the property will be subject to recapture under the Code. Because the property was placed in service prior to 1986, recapture is under Section 1245 of the Code (rather than Section 1250 of the Code, which generally applies to real property).[133] As such, the total amount of the depreciation deductions is subject to recapture as ordinary income.[134]

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

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

Assuming the taxpayer is in the highest income tax bracket and in a relatively high income tax state, like a New York City taxpayer, the ordinary rate would be approximately 45% and the long-term capital gain rate would be approximately 37%. The total tax liability would be $8.2 million. After repayment of the $15 million of debt, the taxpayer (who would net $5 million in cash from the transaction before taxes) would actually be in deficit by approximately -$3.2 million after the payment of income taxes.

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[131] §§ 1016(a)(2), 168(a), and Treas. Reg. § 1.1016-3(a)(1)(i).

[132] Accelerated Cost Recovery System ("ACRS") was enacted in 1981 under the Economic Recovery Tax Act of 1982 ("ERTA"), P.L. 97-34. ACRS was later modified by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), P.L. 97-248, and the Tax Reform Act of 1984, P.L. 98-369, when the recovery period for most real property was extended from 15 to 18 years. In 1985, the real property recover period was extended from 18 to 19 years, P.L. 99-121, § 103. ACRS generally applies to property placed in service after December 31, 1980, and before December 31, 1986. Prop. Treas. Reg. § 1.168-4(a). The Tax Reform Act of 1986, P.L. 99-514, ("TRA 1986") dramatically changed the applicability of ACRS to real property investments and instituted the modified ACRS ("MACRS"). Notably, the "applicable recovery period" for most real property assets like buildings are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods. § 168(c). In this example, because it was placed in service before 1984, the building would be considered 15-year real property, pursuant to which the applicable percentage of depreciation was 12% in the first year, reducing to 5% in from 11 to 15 years.

[133] § 1245(a)(5) before being amended by TRA 1986, defines "§1245 recovery property" to include all recovery property under ACRS, real or personal, other than certain types of 19-year (18-year for property placed in service after March 15, 1984, and before May 9, 1985; and 15-year for property placed in service before March 16, 1984) real property and low-income housing: residential rental property, property used "predominantly" outside the United States, property as to which an election to use straight-line recovery is in effect, and certain low-income and Federally insured residential property. The foregoing types of property are subject to recapture under Section 1250 of the Code. In this example, the office building does not fall within the listed categories, and as such is subject to recapture under Section 1245 of the Code.

[134] *See* § 1245(a)(2).

(4) Compare the result if the taxpayer died owning the building. The building would get a "step-up" in basis under Section 1014(a) of the Code to fair market value, the recapture and long-term capital gain tax problem would be eliminated. If the taxpayer has $5.34 million of Applicable Exclusion available, the maximum estate tax liability (assuming a top state death tax rate of 16% and state death tax exemption equal to the federal exclusion amount) is approximately $7.3 million (maximum blended rate of 49.6%). If the Applicable Exclusion Amount grows to $8 million for example, then the estate tax liability falls to a bit less than $6.0 million. If the foregoing building was in California, the income tax liability would be greater, and the estate tax cost would be even less because California does not have a death tax. With an Applicable Exclusion Amount of $5.34, the estate tax liability is less than $5.9 million.

(5) Property placed in service after 1986 will not have as egregious of an income tax problem because the gain would not have recapture calculated under Section 1245 of the Code. Rather, Section 1250 would be the applicable recapture provision. "Section 1250 property" means any real property, with certain exceptions that are not applicable,[135] that is or has been property of a character subject to the allowance for depreciation.[136] Section 1250(a)(1)(A) of the Code provides that if Section 1250 property is disposed of, the "applicable percentage" of the lower of the "additional depreciation" in respect of the property or the gain realized with respect to the disposition of the property shall be treated as ordinary income. In short, Section 1250 provides that all or part of any depreciation deduction in excess of straight-line depreciation is recaptured as ordinary income.[137] Under the current depreciation system, straight-line deprecation is required for all residential rental and nonresidential real property.[138] As such, Section 1250 recapture is typically not a problem for property placed in service after 1986. The Code does, however, tax "unrecaptured Section 1250 gain" at a 25% tax rate. Unrecaptured Section 1250 gain is essentially the lesser of all depreciation on the property or the net gain realized (after certain losses) to the extent not treated as ordinary income under Section 1250 of the Code.[139]

(6) From an estate planning perspective, it is important to remember that even if recapture is inherent in an appreciated property, it does not apply to a disposition by gift or to a transfer at death, unless the recapture would be considered income in respect of a decedent.[140]

c. Today, most real property investments are not held individually, but are held typically in an entity taxable as a partnership (for example, a limited liability company or limited partnership). When real property investments are the subject to refinancing followed by a distribution of the loan proceeds, the partnership debt rules under Section 752 of the Code must be considered when determining the income tax cost of selling such property. Any increase in a partner's share of partnership liabilities (whether recourse or nonrecourse to such partner) is treated as a contribution of money by the partner to the partnership, resulting in an increase in the

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[135] § 1245(a)(3).

[136] § 1250(c).

[137] § 1250(b)(1), (3), (5).

[138] § 168(b)(3)(A)-(B).

[139] § 1(h)(6).

[140] § 1250(d)(1) and (2).

partner's basis in his or her partnership interest ("outside basis").[141] Any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner, resulting in a decrease in the partner's outside basis.[142] A partner's outside basis may not be reduced below zero, so a deemed distribution of money that arises from a decrease in a partner's share of liabilities will give rise to gain recognition.[143]

d. In the example described above, consider if a partnership owned a fully depreciated $20 million building. The partnership has $15 million of debt which is in excess of the basis in the building and in excess of the taxpayer's outside basis. Assume for this example that we can ignore other partners because they have relatively insubstantial interests in the partnership. When a partner has a negative capital account, so that the outside basis is less that the partner's share of partnership liabilities, it is also colloquially called "negative basis." As discussed, this is a misnomer because basis can never go below zero. [144] A transfer by the taxpayer, whether a taxable sale or a gift to a non-grantor trust, creates what is often referred to as "phantom gain" because the transferee takes over the transferor partner's negative capital account. It should also be noted that a partner who sells his or her partnership interest must include in income his or her allocable share of the partnership's recapture from depreciated partnership property.[145] The transfer results in a decrease in the transferor partner's share of liabilities, which in turn is treated as a distribution of money to the partner when the partner has an outside basis of zero, resulting in gain in a donative transfer or additional gain in the case of taxable sale.[146]

e. When dealing with highly appreciated, depreciable assets like real property and partnership debt, taxable sales of the property and inter-vivos transfers of partnership interests can be problematic. [147] In many cases, given reduced transfer tax rates and growing Applicable Exclusion Amounts, it will make more economic sense to die owning these assets, than to transfer during the partner's lifetime. The transfer of a partner's interest on death is a disposition that does not result in gain or loss recognition, even if the liability share exceeds outside basis.[148] The outside basis of the decedent receives a "step-up" in basis to fair market value (net of liabilities) but is also increased by the estate's share of partnership liabilities.[149]

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[141] §§ 752(a) and 722. Treas. Reg. § 1.752-1(b).

[142] §§ 752(b) and 733. Treas. Reg. § 1.752-1(c).

[143] § 731(a) or 751.

[144] Partnership borrowings and payments of liabilities do not affect the capital accounts, because the asset and liability changes offset each other. See Treas. Reg. § 1.704-1(b)(2)(iv)*(c)*.

[145] §§ 751 and 453(i)(2). Under § 751, unrealized receivables are deemed to include recapture property, but only to the extent the unrealized gain is ordinary income. Treas. Reg. § 1.751-1(e) and (g).

[146] Rev. Rul. 84-53, 1984-1 C.B. 159, Situation 4.

[147] *See* Steve Breitstone and Jerome M. Hesch, *Income Tax Planning and Estate Planning for Negative Capital Accounts: The Entity Freeze Solution*, 53 Tax Mgmt. Memo. 311 (08/13/12).

[148] *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995), and Louis A. del Cotto and Kenneth A. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

[149] §§ 1014(a), 1014(b), 742; Treas. Reg. §§ 1.1014-1(a), (b), and 1.742-1. The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d) of the Code, and (ii) the computation of the basis

Further, if the partnership makes an election under Section 754 of the Code, the underlying assets in the partnership will also receive a "step-up" in basis.[150] Even if a Section 754 election is not made, the estate or the successor beneficiaries of the partnership interest can get the benefit of a "step-up" in the underlying assets if the successor partner makes an election under Section 732(d) of the Code and if the partnership distributes the assets for which there would have been a basis adjustment.[151] Note, the election must be made in the year of the distribution if the property is depreciable, depletable, or amortizable.[152]

4. Traditional IRA and Qualified Retirement Assets

a. In 2013, Investment Company Institute estimated that total retirement assets were over $20 trillion (including government plans, private defined benefit plans, defined contribution plans and individual retirement accounts).[153] Assets in IRAs and defined contribution plans totaled more than ½ of the total at approximately $11.1 trillion. Although IRA and qualified retirement assets make up one of the largest asset types of assets owned by individuals, they are one of the most problematic from an estate planning perspective.

b. IRA and qualified retirement assets are not transferable during the lifetime of the owner,[154] so the assets are never candidates for lifetime gifts unless the owner is willing to incur a taxable distribution of the assets. As such, to the extent not drawn-down prior to death, the assets are includible in the estate for transfer tax purposes,[155] and by definition, the assets will use some or all of the decedent's Applicable Exclusion Amount, unless the assets to surviving spouse under the marital deduction under Section 2056 of the Code or to a charitable organization under Section 2055 of the Code.[156] To make things worse, IRA and qualified retirement assets are considered income in respect of a decedent (IRD) under Section 691 of the Code.[157] IRD assets are not entitled to a "step-up" in basis,[158] and all distributions (whether paid over time or not) to a beneficiary are taxable as ordinary income.[159] Even though the beneficiary

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adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3). The election must be made in the year of the distribution if includes depreciable, depletable or amortizable property, but if

[150] § 743(a).

[151] § 732(d) and Treas. Reg. §1.732-1(d)(1)(i)-(iii).

[152] If the property is not depreciable, depletable or amortizable, the election can be made up until the first year in which basis has tax significance. Treas. Reg. § 1.732-1(d)(2).

[153] Investment Company Institute, *Release: Quarterly Retirement Data, First Quarter 2013*, http://www.ici.org/research/stats/retirement/ret_13_q1, (03/31/201).

[154] *See* the anti-alienation provision in § 401(a)(13)(A).

[155] § 2039(a).

[156] The IRS has taken the position that qualified retirement assets used to fund a pecuniary bequest to a charitable organization will be considered an income recognition event, triggering ordinary income. CCA 200644020.

[157] *See e.g.*, *Ballard v. Commissioner*, T.C. Memo 1992-217, *Hess v. Commissioner*, 271 F.2d 104 (3d Cir. 1959), Rev. Rul. 92-47, 1992-1 C.B. 198, Rev. Rul. 69-297, 1969-1 C.B. 131, PLR 9132021, and GCM 39858 (9/9/91).

[158] § 1014(c).

[159] §§ 72, 402(a) and 408(d)(1), assuming the decedent owner had no nondeductible contributions. *See* § 72(b)(1) and (e)(8).

is entitled to an income tax deduction[160] ("IRD deduction") for estate taxes payable by virtue of the inclusion of the assets, there is no Federal income tax deduction for state death taxes that might be payable, and given the reduced Federal transfer tax rate of 40% and the cost-of-living increase on the Applicable Exclusion Amount, many taxpayers will have very little or no IRD deduction to shelter the on-going ordinary income tax problem.

c. A distribution from a decedent's IRA to a surviving spouse may be "rolled over" to another qualified retirement plan or IRA, thereby deferring the recognition of income.[161] In addition, if the surviving spouse is the beneficiary of all or a portion of the decedent's IRA, the surviving spouse may also elect to treat the decedent's IRA as his or her own IRA.[162] In both of the foregoing cases, the IRD problem discussed above continues after the death of the surviving spouse (unless the surviving spouse remarries).

d. Contrast the foregoing treatment with Roth individual retirement plans ("Roth IRAs").[163] Roth IRA assets are treated similarly to assets in a traditional IRA in that: (i) the account itself is not subject to income tax;[164] (ii) distributions to designated beneficiaries are subject to essentially the same required minimum distribution rules after the death of the original Roth IRA owner;[165] and (iii) surviving spouses may treat a Roth IRA as his or her own and from that date forward the Roth IRA will be treated as if it were established for the benefit of the surviving spouse.[166] In contrast to a traditional IRA, distributions to a qualified beneficiary are not taxable to the beneficiary,[167] and as discussed above, are not subject to the Medicare tax.[168] The overall result for decedents with Roth IRA assets, the qualified beneficiaries of the Roth IRA effectively receive the benefit of a "step-up" in basis. Since 2010,[169] all taxpayers regardless of adjusted gross income[170] can convert traditional IRA assets into a Roth IRA. The conversion is considered a taxable event causing the converted amount to be includible in gross income and taxable at ordinary income tax rates.[171] Direct taxable rollovers from qualified company-based retirement accounts (Section 401(k), profit sharing, Section 403(b), and Section 457 plans) into a Roth IRA.[172] Individuals who have excess qualified retirement assets, have sufficient funds to

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[160] § 691(c)(1).

[161] § 402(c)(9).

[162] Treas. Reg. § 1.408-8, Q&A-5(a).

[163] § 408A.

[164] Treas. Reg. § 1.408A-1, Q&A-1(b).

[165] Treas. Reg. § 1.408A-6, Q&A-14. One specific exception is the "at-least-as-rapidly" rule under § 401(a)(9)(B)(i).

[166] Treas. Reg. § 1.408A-2, Q&A-4.

[167] § 408A(d)(1).

[168] § 1411(c)(5).

[169] Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, effective for tax years beginning after December 31, 2009.

[170] Prior to this change, only taxpayers having less than $100,000 in modified adjusted gross income could convert a Traditional IRA to a Roth IRA. Former § 408A(c)(3)(B).

[171] § 408A(d)(3)(A)(i).

[172] *See* Notice 2008-30, 2008-12 I.R.B. 638 (3/24/2008) and Notice 2009-75, 2009-39 I.R.B. 436 (9/28/2009). § 408A(d)(3)(A).

pay the resulting tax liability from outside of the retirement account, and who are not planning to donate the asset to a charitable organization are great candidates to do a Roth IRA conversion. Notwithstanding the clear benefits of passing the Roth IRA assets to children and grandchildren outside of the scope of the IRD provisions, not many individuals are willing to pay the income tax cost of the conversion.

5. Passive Foreign Investment Company (PFIC) Shares

a. A PFIC is a foreign corporation, 75% or more of the gross of which is "passive,"[173] or the average percentage of assets that produce passive income of which is at least 50%.[174] The PFIC rules do not apply to any U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation.[175]

b. The PFIC rules generally provide that when a U.S. shareholder receives a distribution from a PFIC, rather than treating them under the normal rules of U.S. taxation (e.g., dividend treatment), a special tax regime applies. Under the PFIC tax regime, distributions from a PFIC will be treated either as "excess" or "nonexcess" distributions.

(1) An excess distribution is any portion that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder's shares within the 3 preceding years (or shorter if the shareholder has held the shares for less than 3 years).[176] All other distributions or portions thereof are treated as nonexcess distributions.

(2) With respect to nonexcess distributions, the normal rules of U.S. taxation apply, which generally results in dividend treatment.[177] However, the dividend will not be considered a qualified dividend taxable at 20% because a PFIC will never be a "qualified foreign corporation."[178]

c. The portion of any distribution that is considered an excess distribution will first be allocated to the each day in the shareholder's holding period for the shares.[179] Any portion so allocated to the current year and the non-PFIC years will be included in the year of receipt as ordinary income (not qualified dividends).[180]

d. The portion of the excess distribution that is allocated to other years (the "PFIC years") is not included in the shareholders income, but is subject to a "deferred tax."[181] The deferred tax is added to the tax that is otherwise due. In computing the "deferred

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[173] § 1297(a)(1). Generally, "passive income" is foreign personal holding company income, as provided in § 954(c) of the Code. § 1297(b).

[174] § 1297(a)(2).

[175] § 1297(e).

[176] § 1291(b)(2)(A).

[177] Prop. Treas. Reg. § 1.1291-2(e)(1).

[178] *See* § 1(h)(11)(C)(iii).

[179] § 1291(a)(1)(A).

[180] § 1291(a)(1)(B).

[181] § 1291(c).

tax" the shareholder multiplies the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year.[182] The shareholder then adds all of the "unpaid" tax amounts for all of the PFIC years, and then computes interest on those unpaid tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal underpayment rate.[183] The deferred tax and interest are separate line items on the individual shareholder's income tax return.[184]

e. The sale of PFIC shares are considered excess distributions to the extent the consideration for the sale are in excess of the shareholder's tax basis in the PFIC shares.[185] Thus, effectively the gain is treated as ordinary income, which is treated as realized ratable over the seller's holding period for purposes of determining the deferred tax and interest for prior years.

f. U.S. shareholders of a PFIC may make a "qualified elective fund" (QEF) election to avoid the excess distribution regime. If the shareholder makes a QEF election, the shareholder must include in gross income a pro rata share of the PFIC's ordinary income and net capital gain each taxable year.[186] If a shareholder makes this election, he or she must have access to the PFIC's books and records so the allocable share of the PFIC's income and gain can be calculated.

g. The death of a U.S. shareholder is not a taxable disposition of the PFIC shares if the death results in a transfer to a domestic U.S. estate or directly to another U.S. taxpayer.[187] By contrast, a transfer upon the death of a U.S. shareholder to a testamentary trust or to a foreign person will be considered at taxable disposition.[188] The proposed Treasury Regulations treat a transfer upon death as a transfer by the shareholder immediately prior to death and thus reportable in the decedent's last tax return.[189]

h. If the PFIC shares are held in a grantor trust, the grantor's death is a taxable disposition unless one of the exceptions applies.[190]

i. PFIC shares are nominally eligible for a "step-up" in basis. However, Section 1291(e)(1) of the Code provides that a succeeding shareholder's basis in PFIC shares is the fair market value of the shares on date of death but then reduced by the difference between the new basis under Section 1014 of the Code and the decedent's adjusted basis immediately before date of death.[191] Thus, a succeeding shareholder's basis in PFIC shares received from a decedent is limited to the adjusted basis of the decedent prior to death.

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[182] § 1291(c)(1).

[183] § 1291(c)(1), (2) & (3).

[184] § 1291(a)(1)(C).

[185] § 1291(a)(2).

[186] § 1293(a).

[187] Prop. Treas. Reg. §1.1291-6(c)(2)(iii)(A).

[188] Prop. Treas. Reg. §1.1291-6(c)(2)(iii)(B).

[189] Prop. Treas. Reg. §1.1291-6(d)(2).

[190] Prop. Treas. Reg. §1.1291-6(c)(3)(iv).

[191] § 1291(e)(1).

j. The foregoing basis reduction rule does not apply to PFIC shares received by a succeeding U.S. shareholder upon the death of a nonresident alien decedent if the decedent was a nonresident alien during his or her entire holding period.[192]

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

A. Generally

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

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

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

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

2. In addition to the foregoing, estate planners will increasingly seek to:

a. Maximize the value of certain assets because the step-up" in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes); and

b. Intentionally create estate tax inclusion, especially if the decedent lives in a state with no state death tax and if the decedent has significant unused Available Exclusion Amount above his or her assets.

B. Swapping Assets with Existing IDGTs

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

2. A common power used to achieve grantor trust status for the IDGT is one described under section 675(4)(C), namely giving the grantor, the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.[193] For income tax purposes, transactions between the grantor and the IDGT will be disregarded.[194] As such, grantors may exercise the power to swap high basis assets for low basis assets without jeopardizing the estate tax includibility of the assets and without having a taxable transaction for income tax purposes.

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[192] § 1291(e)(2).

[193] § 675(4)(C) and Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

[194] *See* Rev. Rul. 85-13, 1985-1 C.B. 184 and PLR 9535026.

3. To maximize the benefits of the swap power, it must be exercised as assets appreciate or are sold over time. When exercised properly, this can ensure that only those assets that benefit the most from the step-up will be subject to estate inclusion.

a. If grantor does not have sufficient other assets, repurchase will be difficult - although the donor could borrow cash from a third party.

b. The income tax consequences if a note is used to repurchase property are uncertain because the trust's basis in note may equal grantor's original carryover basis in the asset given to the trust and now reacquired so paying off the note may generate gain).

c. Because the sudden or unexpected death of the grantor may make a repurchase difficult or impossible, estate planners may want to consider drafting "standby" purchase instruments to facilitate fast implementation of repurchase.

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

> If a person who is a deemed owner under the grantor trust rules of all or a portion of a trust engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust, then the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction) will be subject to estate tax as part of the gross estate of the deemed owner, will be subject to gift tax at any time during the deemed owner's life when his or her treatment as a deemed owner of the trust is terminated, and will be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to the distributee) during the life of the deemed owner.[195]

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

C. Valuation Discounts On or Off?

1. Where assets have been divided among generations to create discounts, consideration should be given to undoing those arrangements if the effect is to depress the value of an estate below the amount of Available Exemption Amount in order to increase the income tax basis of the assets.

2. Discount entities could be dissolved or restated to allow the parties to the entity to withdraw.

[195] Department of the Treasury, *Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts*, General Explanation of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013), p. 145.

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

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

c. The ability of the IRS to ignore provisions of an agreement that increase the value of assets in the hands of a parent, but not in the hands of a child, is uncertain. By its literal terms Section 2703 of the Code applies only to provisions that reduce value and to restrictions on the right to sell or use property. To illustrate, in *Estate of James A. Elkins, Jr., et al. v. Commissioner*,[196] the Tax Court applied Section 2703 of the Code to ignore a family co-tenancy agreement requiring all owners of fractional interests in art to agree before the art could be sold. The purpose of that agreement was to limit the marketability of each fractional interest. But what might the effect on value be of an agreement which provided, instead, that any fractional owner could compel the sale of the entire asset? Similarly, a provision that allows a shareholder in business to put stock to the business at death for fair market value would seem to be outside the scope of the section. In many instances amending old agreements to include such provisions will be more likely to create gift from the younger owners to the older than would terminating an old agreement and creating a new one.

D. General Powers of Appointment

1. Generally

a. A general power of appointment, as defined in the Code,[197] is a power exercisable in favor of: (i) the power holder, (ii) his or her estate, (iii) his or her creditors, or (iv) creditors of his or her estate. From a transfer tax standpoint, the mere existence of an exercisable general power of appointment at the death (a testamentary general power) of the power holder will cause assets subject to the power to be includible in the power holder's estate.[198] Moreover, the lack of knowledge of the existence of a general power of appointment will not exclude the property subject to the power form being included in the estate of the deceased power holder.[199]

b. From an income tax standpoint, if the holder of the power exercises a testamentary general power, the property passing under the power is deemed to have passed from the deceased power holder without full and adequate consideration, and the property will get a "step-up" in basis.[200] If the holder of the power dies without exercising the testamentary general power of appointment, the property that was subject to the power is also deemed to have been acquired from the deceased power holder and such property will receive a "step-up" in basis.[201]

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[196] 140 T.C. No. 5 (2013).

[197] §§ 2041(b)(1) and 2514(c).

[198] § 2041(a)(2) and Treas. Reg. § 20.2041-3(b).

[199] *Freeman Estate v. Commissioner*, 67 T.C. 202 (1976).

[200] Treas. Reg. § 1.1014-2(a)(4).

[201] Treas. Reg. § 1.1014-2(b)(2).

c. Given the potential income tax savings from the "step-up" in basis and growing Applicable Exclusion Amounts in the future, estate planners will need to consider how, under what circumstances and to what extent a testamentary general power of appointment should be granted to future trust beneficiaries, even if the assets have been correctly transferred into a vehicle (like a dynasty trust) that is structured to avoid estate tax inclusion at every generation. So-called "limited general powers" may be helpful in this respect. For example, a power to appoint only to the creditors of the power holder's estate may be less susceptible to undesirable appointment than a power to appoint more broadly. Further, the exercise of a power may be subject to the consent of another person so long as the person does not have a substantial interest adverse to the exercise of the power in favor of the decedent, his or her estate, his or her creditors, or the creditors of his or her estate.[202]

2. Formula

a. One option is to draft a testamentary general power of appointment that by formula absorbs any unused portion of a beneficiary's unused Applicable Exclusion Amount (including any DSUE Amount). This would provide a "step-up" in basis to those assets subject to the power without causing any Federal estate tax liability. In theory, this formula can be drafted with great precision. However, in practice, I believe it is quite difficult to draft, and the formula may be subject challenge by the IRS.

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

(1) A formula that determines the size or amount of the general power of appointment. As mentioned above, in theory, the starting amount of the formula is the Applicable Exclusion Amount as defined in Section 2010(c)(2) of the Code, which would include the Basic Exclusion Amount under Section 2010(c)(3)(A) of the Code, including any increases due to the cost-of-living increase, and any DSUE Amount.

(2) The starting amount would then need to be reduced by any reductions due to taxable gifts that reduced the Applicable Exclusion Amount prior to death and any testamentary transfers that would not otherwise be deductible for Federal estate tax purposes (marital transfers under Section 2056 of the Code and charitable transfers under Section 2055 of the Code).

(3) Once the size of the power of appointment has been so determined, the formula would need to provide that the power is not simply exercisable against all of the assets in trust, but that it is only exercisable against those assets in the trust that would benefit the most from a "step-up" in basis, given the tax nature of the asset (as discussed above). For example, if the trust only held publicly-traded assets, the formula would need to ensure that the power is exercisable against the lowest basis lots of securities, not against the securities that have unrealized losses or the cash. The formula would likely need to determine the total income tax cost (including state income taxes) to the trust in a constructive liquidation of the assets in a taxable transaction for fair market value and then segregate those assets or portion of assets (like a separate lot of stock) that have the highest relative income tax cost compared to fair market value (the highest "effective" income tax cost). Without this refinement, the basis adjustment

[202] Treas. Reg. § 20.2041-3(c)(2).

under Section 1014(a) of the Code will be applied across all of the assets whether they benefit from the "step-up" in basis or not, and if the total value of the assets exceed the size of the general power of appointment, no asset will get a full "step-up" in basis.[203]

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

(5) In determining the "effective" income tax cost in a constructive liquidation of the trust assets, the formula may need to reduce the original size of the power of appointment to take into account any state death tax costs (if the beneficiary dies in a state with a state death tax) that would result from the existence of the general power of appointment. Most states with a death tax have an exemption that is smaller than the Federal Applicable Exclusion Amount, and no state provides for "portability" of a deceased spouse's unused state death tax exemption.[204] As such, formula would need to take into account the "effective" state death tax cost (in comparison to the fair market value of the asset) and compare that to the income tax savings from the "step-up" in basis for the assets with the highest "effective" income tax cost on the date of death. The formula might then reduce the size of the general power of appointment to so that at the very least the "effective" state death tax cost equals (but likely is less than) the "effective" income tax cost of those assets that would be subject to the power of appointment. Note, some states provide that a general power of appointment is not subject to state death tax.[205] Because of the foregoing, drafters may choose to limit the size of the general power of appointment to the lesser of the Applicable Exemption Amount and any applicable state death tax exemption.

(6) To further complicate things, in determining the size of the general power of appointment, the formula will need to consider differences between the Applicable Exclusion Amount and the any remaining GST exemption the beneficiary may have at the time of death. If, for example, Applicable Exclusion Amount is greater than the beneficiary's GST exemption, should the general power of appointment be reduced to the lesser of the two amounts thereby foregoing some portion of the available "free" step-up in basis? Or should the general power of appointment be the greater of the two amounts but provide a different disposition of those assets depending on whether GST exemption is applied to such "transfer" (even in the failure to exercise the power of appointment)? In other words, assets receiving both a "step-up" in basis and application of the beneficiary's GST exemption would continue to stay in the dynasty trust, for example, and assets that only receive "step-up" in basis would be held in a separate "non-exempt" GST trust.

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[203] Similar to the basis adjustment under Section 743 of the Code upon the death of a partner when the partnership makes or has a Section 754 election. *See also* Rev. Proc. 64-19, 1964-1 C.B. 682 , in the marital funding area, which requires that the assets selected for distribution be fairly representative of the appreciation and deprecation between the decedent's death and the funding.

[204] *See* Appendix A (Summary of State Income and Death Tax Rates) at the end of this outline.

[205] Pennsylvania provides that mere existence of a general power of appointment does not cause inclusion of the assets subject to the power for inheritance tax purposes. Under § 9111(k) of Title 72 of the Pennsylvania Consolidated Statutes, property subject to a power of appointment is exempt from Pennsylvania inheritance tax in the estate of the donee of the power of appointment.

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

(1) As noted above, the size of the general power of appointment should be reduced by any transfers that would not otherwise be deductible for Federal estate tax purposes (marital transfers under Section 2056 of the Code and charitable transfers under Section 2055 of the Code). Whether a transfer will qualify for the marital deduction or a charitable deduction may be dependent on a QTIP election under Section 2056(b)(7)(B)(v) of the Code or a qualified disclaimer under Section 2518 of the Code, both of which occur after the date of death. A QTIP election is made on a timely filed estate tax return,[206] and a qualified disclaimer is made 9 months after date of death.[207]

(2) The IRS's argument might be that despite the crux of the Fifth Circuit's ruling in *Clayton v. Commissioner*[208] that a QTIP election relates back to the date of death and the same could be said about qualified disclaimers,[209] these actions do not relate to a general power of appointment under Section 2041 of the Code. The election and disclaimer do, however, affect the size of the general power of appointment. As such, they are similar to a contingency that has not yet occurred on the date of death. In Private Letter Ruling 8516011, the IRS ruled that a marital bequest that was conditioned upon the surviving spouse's survival of the decedent's admission to probate would not be included in the surviving spouse's estate because the spouse died prior to the will being admitted to probate. In the ruling, the IRS stated that even though the spouse had the power to admit the will to probate and thus had a power of appointment, this power of appointment was subject to the formal admission to probate, which in turn requires a substantive determination by the court regarding the validity of the will. As such, the general power of appointment was deemed not to exist for estate tax purposes.[210]

3. Trust protector

a. Because of the complexities of the formula and the risk of challenge by the IRS, estate planners may want to rely upon an independent "trust protector" to grant or modify the terms of a limited power of appointment and expand it to a general power of appointment.[211] This has the obvious benefit of allowing the trust protector to determine the size

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[206] § 2056(b)(7)(B)(v).

[207] § 2518(b)(2).

[208] 976 F.2d 1486 (5th Cir. 1992), *rev'g* 97 T.C. 327 (1991).

[209] *See* § 2518(a) and Treas. Reg. § 25.2518-1(b).

[210] *See* TAM 8551001 and *Kurz Estate v. Commissioner*, 101 T.C. 44 (1993), aff'd, 68 F.3d 1027 (7th Cir. 1995).

[211] *See, e.g.*, Alaska Stat. § 13.36.370(b)(4) ("modify the terms of a power of appointment granted by the trust"); Idaho Code §15-7-501(6)(c) ("To modify the terms of any power of appointment granted by the trust. However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument."); S.D. Codified Law § 55-1B-6(3) ("Modify the terms of any power of appointment granted by the trust. However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument."); Wyo. Stat. § 4-10-710(a)(xi) ("to grant a power of appointment to one (1) or more trust beneficiaries or to terminate or amend any power of appointment granted by the

of the testamentary power of appointment and the assets that will be subject to the power as the situation and the tax laws change in the future.

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

E. Forcing Estate Tax Inclusion

1. Different Strategies for Causing Estate Tax Inclusion

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

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

c. Include a formula in the trust agreement which would cause estate tax inclusion if appreciation is not sufficient for estate tax benefits to outweigh income tax benefits of a step up

(1) Example: I make a gift of $5 million of stock with a basis of 0 to a trust for my children. Trust agreement provides that on my death, if 40% of the excess of the

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trust; however… of a power of appointment may not grant a beneficial interest to any person or class of persons not specifically provided for under the trust instrument or to the trust protector, the trust protector's estate or for the benefit of the creditors of the trust protector.").

date of death value of any asset over the date of gift value of the asset is less than 23.8% of the excess of the date of death value of the asset over the basis of the asset, the asset is distributable to my estate. The formula could be written as follows if (E)*(D-G) < (I)(D-B), asset is distributable, where E=estate tax rate, I=income tax rate, D=date of death value, G=date of gift value, B=basis. If the value of the stock is $7.5 million at my death, the stock would be distributed to my estate so that I get the income tax benefit of the step up, which exceeds my transfer tax savings.

(2) Formula creates an "estate tax inclusion period"[212] ("ETIP") so GST exemption cannot be allocated to the trust.

d. Appoint the donor as trustee, although many trust agreements provide that the donor may never be named as trustee.

e. Move the trust from an asset protection jurisdiction to a jurisdiction where donor's creditors can reach the assets. This would also require that the donor have some beneficial interest in the trust that would cause it to be a self-settled trust.

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

g. Use a freeze partnership so that grantor's retained preferred interest gets a basis adjustment at death.

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

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

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

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

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

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[212] § 2642(f).

2. Tax consequences of estate tax inclusion

a. Value of property at death is includible in gross estate.

b. Section 2001(b) of the Code provides that adjusted taxable gifts do not include gifts that are includible in the gross estate. Thus, there is a distinction between including assets in the estate of a beneficiary and including gifted assets in the estate of the donor.

c. There is no reduction available for gifts treated as having been made by a spouse because of a split gift election, so estate tax inclusion generally should not be used for property for which a split gift election was made.

d. Question of how much is excluded from adjusted taxable gifts where less than all of the gifted property is includible in the estate (e.g. because of distributions of income or distributions of appreciation)?

(1) Does not seem to be addressed under Sections 2001, 2701 and 2702 of the Code and the Treasury Regulations thereunder.

(2) Example: I make a completed gift of $5 million of stock with a zero basis to a trust for my children and the stock is included in my estate as a result of one of the methods described above. During my lifetime any income and appreciation in excess of $5 million is distributed to my children free from transfer tax. On my death, the remaining $5 million of stock is includible in my gross estate and is not included in my adjusted taxable gifts. The basis in the stock will be stepped up to the value on the date of death and the stock can be sold free from capital gains tax.

(3) Example: Same as the previous except that I retain the right to receive trust income during my lifetime. My income interest does not reduce the value of the gift because it does not meet the requirements of Section 2702 of the Code. All appreciation is distributed to my children during my lifetime. On my death, I receive a basis "step-up" and my adjusted taxable gifts are reduced. Under the Treasury Regulations, however, my adjusted taxable gifts are only reduced by the value of my income interest and not by the full $5 million value of the stock.

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

1. Generally

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

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

2. Estate and Generation-Skipping Tax Benefits.

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

(1) Annual exclusion gifts may be made to the parent. The gifts may be made outright or in trust depending on circumstances (e.g., parent may be given a *Crummey* withdrawal right). Discounted gifts may be made although doing so will add benefits to the transaction only if the discount is unlocked prior to parent's death. The benefits of annual exclusion gifts may be significant. To illustrate, $13,000 per year for 10 years at 5% equals $163,000. If child is married and there are even two living parents, then $52,000 for 10 years at 5% exceeds $652,000.

(2) Child could make adjusted taxable gifts to the parent. Although it may appear that such would be a wasted use of the child's gift tax exemption, if the parent is able to leave the $1,000,000 to child and child's descendants without estate or generation-skipping tax then the only waste would be opportunity cost to the extent that other methods could be found to transfer assets to a parent without making a gift.

(3) Child may create a GRAT that has a vested remainder in parent. That is, the GRAT assets, after the annuity term ends, will be paid to parent or to parent's estate. The value of the remainder will be included in parent's estate and will pass in accordance with parent's estate plan.

(4) Parent's executor may allocate generation-skipping tax exemption to the remainder interest without regard to any ETIP under Section 2642(f) of the Code because parent has not made an inter-vivos transfer of property that would be included in parent's estate immediately after the transfer. The amount allocated would be equal to the fair market value of the remainder interest. Where the GRAT term is 10 years (or longer), and is back-weighted, the remainder value will remain a comparatively small percentage of the GRAT for the first several years of the term. Upstream GRATs will, in general, have longer terms that GRATs that are designed to transfer assets immediately to children. Commentators have speculated that a GRAT may be created with a vested interest in a child, with that child immediately transferring the remainder interest to that child's children and allocating that child's GST exemption at the time of transfer. There is no authority on whether such a transaction achieves the intended result. Private Letter Ruling 200107015 ruled negatively on the assignment of a remainder interest in a charitable lead annuity trust primarily on the grounds that Section 2642(e) of the Code is specifically designed to limit the ability to leverage generation skipping tax exemption by using a charitable lead annuity trust. Here the GRAT remainder is not being transferred at the time of its creation, but rather at its fair market value at a later time (the death of the parent owner). Use of an Upstream GRAT presents several advantages compared with a child's assignment of a remainder interest to grandchildren. Because GST exemption that would otherwise be wasted is being used there is no, or certainly less, pressure to keep the remainder interest in parent's estate at zero or a de minimis value and the value changes depending on when parent dies (a date that in almost all instances will be uncertain). If a concern is that the value of the remainder interest could exceed the threshold beyond which parent's estate would be required to pay Federal estate tax (or file an estate tax return), then the amount vested in parent could be fixed by a formula tied to the remaining assets in parent's estate. Suppose a 10 year GRAT is funded with $1,000,000 with annual payments that increase at 20% per year is created in a month when the section 7520 rate is 2.0%. The annual payments required to zero-out the GRAT are $44,125. Further, suppose that parent dies at the end of year 5 when the Section

7520 rate is 5.0%, and the value of the trust assets have grown at 6% per year. The value of the GRAT will be $975,740 with five years of payments remaining and the value of the remainder will be about $403,000.

3. Income Tax Benefits

Assets included in a parent's estate for estate tax purposes obtain a new income tax basis under Section 1014(b)(9) of the Code but not if assets acquired by the parent from a child by gift within one year of the parent's death pass back to the child or the child's spouse.[213]

4. Creditor Protection for Child

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

b. The lapse of a *Crummey* withdrawal right may be a state law transfer, although most practitioners and trustees do not treat it as such, except in those states which provide specifically to the contrary. A safer approach would be to have parent exercise parent's power of appointment in favor of a new trust for the benefit of child. If the power is general the parent should become the grantor of the trust for state law purposes.

5. Limiting Parent's Ability to Divert Assets

a. The strategies called for require that parent have a testamentary general power of appointment. A power limited to the appointment of assets to the creditors of a parent's estate will be a general power under Section 2041(b)(1) of the Code. If it is desirable that a parent have additional discretion the parent could be given a power to appoint to descendants, with or without charities, and such additional powers could be conditioned on the consent of child or others because all that is required in order to capture the tax benefits is the limited testamentary general power.

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

6. Parent's Creditors.

a. A parent who has or is likely to have creditors will not be a good candidate for these sorts of transactions. Creditors could include health-care providers or

[213] § 1014(e).

Medicaid, tort victims (is parent still driving would be a key consideration), and beneficiaries of legally binding charitable pledges.

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

7. Accidentally Perfect Grantor Trust

a. Using a parent's unused Applicable Exemption Amount and GST exemption and benefiting from a "step-up" in basis but still retaining grantor trust status after the parent's death is the goal of a planning technique that has been called the "Accidentally Perfect Grantor Trust" (APGT).[214] Pursuant to this technique, a younger generation establishes an IDGT and moves wealth into the IDGT (e.g., pursuant to an installment sale) the terms of which provide that the parent is a beneficiary of the IDGT and is granted a testamentary general power of appointment over the IDGT's appreciated assets equal to the parent's unused Applicable Exemption Amount and GST exemption (e.g., pursuant to a formula provision, as discussed above). Upon the death of the parent, the assets may be held for the benefit of the younger generation grantor and his or her descendants.

b. In order to be successful, the APGT must avoid estate tax inclusion at the younger generation's level under Sections 2036 through 2038 of the Code, cause estate tax inclusion at the parent's passing, and provide for a "step-up" in basis for the estate tax includible assets.[215]

c. From an income tax standpoint, whether the ongoing trust will continue to be a grantor trust with respect to the younger generation or a non-grantor trust depends on whether the parent exercises the general power of appointment or allows it to lapse. The Treasury Regulations provide:

> If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.[216]

d. Thus, if the ongoing trust arises because the parent exercises the general power of appointment, then the parent is the grantor for income tax purposes, and the ongoing trust will be a non-grantor trust for income tax purposes. More significantly, the

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[214] For an excellent discussion of this technique, see Mickey R. Davis & Melissa J. Willms, *Trust and Estate Planning in a High-Exemption World and the 3.8% "Medicare" Tax: What Estate and Trust Professionals Need to Know*, The Univ. of Tex. School of Law 61st Ann. Tax Conf. – Est. Pl. Workshop (2013).

[215] *But see* PLR 200101021 on the applicability of Section 1014(e) of the Code.

[216] Treas. Reg. § 1.671-2(e)(5).

argument goes, if the ongoing trust is created as a result of the failure to exercise or lapse of the general power of appointment, then the trust will continue to be a grantor trust with respect to the younger generation who is also a potential beneficiary of such trust ongoing trust.

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

1. Generally

a. Notwithstanding the popularity of the estate planning technique that involves the sale of assets to an IDGT for an installment sale note, the tax ramifications of the death of the grantor when the note is still outstanding is still unclear. Most commentators and practitioners agree that nothing occurs for income tax purposes until grantor trust status terminates.[217]

b. Many would agree that if grantor trust status is terminated during the lifetime of the grantor, a transfer is deemed to occur and the grantor may recognize gain to the extent the amount owed to the grantor exceeds the grantor's basis in the assets. The IRS has ruled that when the grantor of a grantor trust that holds a partnership interest that is subject to liabilities renounces grant trust status, the grantor is treated as transferring the partnership interest to the trust. When the interest transferred is a partnership interest and the grantor's share of the partnership liabilities is reduced, the grantor is treated as having sold the partnership interest for an amount equal to the grantor's share of the reduced liabilities.[218] The Treasury Regulations also provide that if a taxpayer creates a grantor trust which purchases a partnership interest and the grantor later renounces grantor trust status, then the taxpayer is considered to have transferred the partnership interest to the trust. The taxpayer's share of liabilities that are eliminated as a result of the transfer are considered part of the amount realized for income tax purposes.[219]

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

d. There is unfortunately no dispositive authority on the income tax consequences on the assets in the IDGT and on the outstanding installment note at the death of the grantor. It is beyond the scope of this outline to discuss the intricacies of the arguments that have been posed, but there are a number of resources that are publicly available that will serve as better resources.[220] However, given the nature of estate planning today (maximizing the "step-up" in basis), some discussion of the subject is warranted.

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[217] *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

[218] Rev. Rul. 77-401, 1977-2 C.B. 122

[219] Treas. Reg. § 1.1007-2(c), Ex. 5. *See also* TAM 200011005.

[220] *See, e.g.*, 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), 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), Ron Aucutt, *Installment Sales to Grantor Trusts*, 2 Bus. Entities 28 (2002).

2. Assets in IDGTs

a. Generally

(1) Notwithstanding arguments to the contrary,[221] the conventional view is that if the assets in the IDGT are not included in the grantor's gross estate, the trust assets will not receive a "step-up" in basis under Section 1014 of the Code. [222] Most practitioners and commentators take the position that whatever assets happen to be in the IDGT at the time of the grantor's death carry their historical tax basis. Hence, the reason swapping high basis assets with low basis assets in existing IDGTs will continue to be so important prior to the death of the grantor.

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

b. PLR 201245006

(1) In PLR 201245006, the taxpayer asked the IRS how to determine the basis of property upon the death of the grantor for property owned by an irrevocable non-U.S. situs (foreign) trust. The taxpayer ("Taxpayer") was a foreign citizen and non-resident of the United States. Taxpayer proposed to transfer assets to an irrevocable trust ("Trust") established under the laws of Taxpayer's country ("Country"). The assets of Trust were to include cash and stock in two companies that are publicly traded in Country and on the New York Stock Exchange. The trustees of Trust are Taxpayer and X, an unrelated party ("Trustees"). Trustees were to pay all Trust income to Taxpayer during his lifetime and could distribute principal to Taxpayer in their absolute discretion. Upon Taxpayer's death, Taxpayer had a special testamentary power of appointment over the income and principal of Trust in favor of his issue. If Taxpayer did not exercise his special power of appointment, Trust property would be held in further trust for the benefit of Taxpayer's issue.

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[221] *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).

[222] *See* CGA 200937028, dealing with a case where the taxpayer transferred assets into a trust and reserved the power to substitute assets. In the ruling, the chief counsel quotes from Section 1.1014-1(a) Treasury Regulations: "The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death. . . . Property acquired from the decedent includes, principally . . . property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]" From this the chief counsel concludes, "Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9)."

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

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

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

(4) In coming to the conclusion, the ruling points out that "Section 1014(b)(9)(C) provides that § 1014(b)(9) shall not apply to property described in any other paragraph of § 1014(b)." In other words, inclusion in the gross estate may not necessarily be the only avenue to receive a "step-up" in basis.

(5) While some practitioners may seek to interpret this ruling as allowing a "step-up" in basis for assets in an irrevocable grantor trust that are not otherwise included in the gross estate of the grantor, in actuality, after discussing the matter with the attorneys who represented the taxpayer in the ruling, it appears the drafters of the ruling may have mistakenly referred to Section 1014(b)(1) of the Code ("Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.") in the ruling. According to the attorneys, the ruling should have referred to Section 1014(b)(3) of the Code, which provides for a "step-up" in basis for "property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust."[223] While not clear in the ruling, the grantor retained the power to alter beneficial enjoyment from and after his death, not during his lifetime.[224] As such, this ruling does not stand for the proposition that assets in an IDGT can receive a "step-up" in basis, notwithstanding the fact the assets are not includible in the estate of the grantor.

[223] § 1014(b)(3).

[224] The drafters of the trust could not provide for a lifetime power to change beneficial enjoyment without losing foreign grantor trust status. The Code provides grantor trust status with respect to a foreign person for a portion of any trust if "the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor." § 672(f)(2)(A)(ii).

3. Installment Notes

a. Generally

(1) As noted above, while grantor trust exists, nothing is deemed to have occurred for income tax purposes. As such, the grantor-seller in an installment sale to an IDGT effectively has no tax basis at all.[225] The concept of tax basis is moot until grantor trust status terminates, on death or otherwise.

(2) Except for transactions between a grantor and a grantor trust, it is well-established that installment obligations[226] are a form of IRD if the grantor-seller dies with the note outstanding. Section 453B(c) of the Code provides that the general rule concerning immediate recognition of gain or loss on the subsequent transfer of an installment obligation at death is inapplicable, and the installments will be subject to the IRD rules under Section 691 of the Code.[227] Thus, the installment note will not be entitled to "step-up" in basis.

(3) The issue of what happens with an installment obligation from an IDGT when a grantor dies has not been settled. Some have argued that the installment obligation is IRD. Others have argued that the installment note is not IRD, but the death of the grantor will be a taxable event (as it would be if grantor trust had been terminated during the lifetime of the grantor). As such, gain is recognized on the last income tax return of the decedent in an amount equal to the outstanding debt and the basis of the assets deemed to be transferred at such time.[228] Most practitioners and many commentators believe the installment obligation is not IRD and death is not a recognition event.[229] Thus, the installment obligation is entitled to a "step-up" in basis under Section 1014 of the Code.[230]

b. Valuation

(1) If the installment obligation is outstanding at the time of the grantor's death, the grantor's estate will be included in the estate at its fair market value. The Treasury Regulations provide:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless.

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[225] *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

[226] Generally, obligations reportable by the grantor-seller under the installment method under § 453.

[227] Treas. Reg. § 1.691(a)-5.

[228] *See Madorin v. Commissioner*, 84 T.C. 667 (1985), Rev. Rul. 77-402, 1977-2 C.B. 222, and Treas. Reg. § 1.1001-2(c), Ex. 5 and 6.

[229] *See* GCM 200923024 (After providing that a taxable event occurs when grantor trust is terminated during the lifetime of the grantor, the memorandum does on to say, "We would also note that the rule set forth in these authorities is narrow, in so far as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.").

[230] *See, e.g.*, 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), and 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).

> However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.[231]

(2) The IRS has agreed that "all available data and all relevant factors affecting the fair market value must be considered"[232] in determining the value of a promissory note, and face value is not necessarily the value to be included in the gross estate.

(3) Many practitioners have, in the past, claimed valuation discounts on installment note obligations included in the estate due to a number of factors including a low interest rate, lack of security, and the obligor's inability to pay the note as it becomes due.[233] Practitioners may want to consider whether a valuation discount should be claimed today if the obligation will be entitled to a "step-up" in basis to fair market value at little or no transfer tax cost (assuming there is sufficient Applicable Exemption Amount available at the time of the grantor's death).

(4) Interestingly, in transfers to a related person[234] that trigger Section 691(a)(2) of the Code (subsequent transfers of IRD assets, including a transfer to the obligor that would result in a cancellation of the indebtedness), the Code mandates that the fair market value of the obligation (and the amount that would be recognized at such time) may not be less than the face value of the obligation.[235]

c. SCINs and CCA 201330033

(1) Self-cancelling installment notes ("SCINs") have been used in conjunction with IDGTs to circumvent estate inclusion of the value of the note upon the death of the grantor. Generally, a SCIN is a promissory note where the remaining debt is cancelled upon the death of the note holder. With a SCIN, a risk premium must be added as additional consideration for the death on cancellation feature. The risk premium can be in the form of additional principal or additional interest. The calculation of the risk premium is based on mortality tables and a discount rate (i.e., an interest rate). However, there is no clear authority as to what interest rate and what mortality table must be used to compute the risk premium for SCINs.

(2) In CCA 201330033, the chief counsel of the IRS advised that a sale of stock in exchange for installment notes and SCINs resulted in a taxable gift.

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[231] *See* Treas. Reg. § 20.2031-4

[232] TAM 8229001.

[233] *See* M. Read Moore, *Valuation Discounts for Private Debt in Estate Administration*, 25 Est. Plan. 195 (1998) and Jerry M. Hesch, Alan S. Gassman, and Christopher J. Donicolo, *Interesting Interest Questions: Interest Rates ,for Intra-Family Transactions*, 36 Est. Gifts & Tr. J. 128 (2011).

[234] Referring to the definition under § 453(f)(1), which in turn refers, generally, to the definition under §§ 318(a) or 267(b).

[235] § 691(a)(5)(B).

(a) The situation described in the ruling involved a series of estate planning transactions including gifts to IDGTs, exchanges of assets with IDGTs, transfers to GRATs, and sales of assets to IDGTs in exchange for a series of promissory notes. All of the notes provided for annual interest payments during the terms of the notes and for principal to be paid at the end of the terms. Some of the notes were for a term of years based upon the decedent's life expectancy as determined under the mortality tables under Section 7520 of the Code. Some of the notes were SCINs that provided for a risk premium in the form of additional principal and some were SCINs that provided for a risk premium in the form of additional interest. In calculating the risk premiums, the additional principal and interest specifically were based upon the Section 7520 tables, according to the ruling. The taxpayer was diagnosed with a health condition shortly after the transactions and died within six months of these transactions.

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

> We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986).

(c) This ruling seems to be one of first impression, casting doubt on the general practice of using the Section 7520 mortality tables and concepts in calculating the risk premium associated with SCINs.

(d) Because the last ruling requested was predicated upon no taxable gift, the chief counsel essentially did not need to rule on the estate tax implications of the transactions at hand. However, the ruling did note similarities to the situation described in *Musgrove vs. United States*,[236] where the court ruled that the decedent retained an interest in the amount transferred and thus estate tax inclusion was warranted.

[236] 33 Fed. Cl. 657 (1995).

V. TAX BASIS MANAGEMENT AND THE FLEXIBILITY OF PARTNERSHIPS

A. Generally

1. There are limited ways of changing the basis of an asset without having a recognition event for income tax purposes. The donee of a gift generally acquires "carryover" basis[237] increased by any Federal gift tax paid attributable to any appreciation in the property transferred.[238] Moreover, if the fair market value of the gift is less than the donor's basis, the donee's basis on a subsequent sale of the property will depend on whether the sale creates a gain or a loss. If the donee recognizes a loss, the donee's basis for purposes of determining the recognizable amount of such loss is the fair market value of the property at the time of the gift. If the donee recognizes a gain, the donee's basis for purposes of determining the recognizable amount of such gain is the donor's basis at the time of the gift. A sale at an amount somewhere in between the basis for determining loss and the basis for determining gain results in no gain or loss recognized. [239] As discussed above, the basis of most assets will get a "step-up" in basis if acquired from a decedent under Section 1014(a) of the Code.

2. Estate planners should consider using entities treated as partnership for tax purposes to proactively manage the tax basis of the assets of families. The partnership rules provide sufficient planning flexibility to shift and change the basis of property through distributions (both non-liquidating and liquidating distributions) and the use of certain elections like the Section 754 election. For example, a partnership could distribute a high basis asset into the hands of a partner with zero outside basis. The basis of the property in the hands of the partner generally would become a zero basis asset eligible for a "step-up" in basis on the subsequent death of the partner.[240] With a Section 754 election, the "stripped" basis (i.e., the partnership's basis in the asset immediately prior to the distribution) would allow an upward basis adjustment to the other assets remaining inside the partnership.[241] Furthermore, because partnership debt can create tax basis to certain partners, the careful management of each partner's allocable share of that debt can increase or decrease basis.[242] Notwithstanding the general rules above, other provisions of subchapter K must be considered, including the "mixing bowl" transaction and disguised sale rules.[243]

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

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[237] § 1015(a).

[238] § 1015(d).

[239] § 1015(a) and Treas. Reg. § 1.1015-1(a)(1) & (2).

[240] §§ 732(a)(2) and 1014(a).

[241] § 734(b).

[242] § 752.

[243] §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b).

a. Unitary basis rules;

b. Non-liquidating "current" distributions of partnership property;

c. Liquidating distributions of partnership property;

d. "Mixing Bowl" transactions;

e. Partnership liabilities and basis;

f. Section 754 election and inside basis adjustments;

g. Partnership divisions; and

h. Anti-abuse rules.

B. Anti-Abuse Rules

1. In 1995, the IRS issued "anti-abuse" Treasury Regulations[244] that permit the IRS to recharacterize any transaction that involves a partnership if a principal purpose of the transaction is to reduce the present value of the partners' "aggregate Federal tax liability" in a manner inconsistent with the intent subchapter K.[245] The breadth of these provisions are potentially infinite, but generally apply to artificial arrangements. The discussion herein focuses on only those arrangements that result in changes in tax basis in light of attempting to maximize the "step-up" in basis.

2. The Treasury Regulations provide that the following requirements are implicit in the "intent" of subchapter K:

a. The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose;

b. The form of each partnership transaction must be respected under substance over form principles; and

c. The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income).[246]

3. The Treasury Regulations provide that certain of the factors that may be taken into account in determining whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner inconsistent with the intent of subchapter K. Some of those factors are:

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[244] Treas. Reg. § 1.701-2.

[245] Treas. Reg. § 1.701-2(b).

[246] Treas. Reg. § 1.701-2(a).

a. The fact that substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another'

b. The present value of the partners' aggregate Federal tax liability is substantially less than it would have been had the partners owned the partnership's assets and conducted the partnership's activities directly;

c. The benefits and burdens of ownership of contributed property are retained by the contributing partner or of partner, or the benefits and burdens of ownership of partnership property are shifted to the distributee partner, before and after the property actually distributed;

d. The present value of the partners' aggregate Federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction; and

e. Partners who are necessary to claiming a certain tax position but who have a nominal interest in the partnership, are substantially protected from any risk of loss, or have little or no participation in profits other than a preferred return that is a payment for the use of capital.[247]

4. Pertinent to the concept of changing the tax basis of property, the Treasury Regulations provide 2 examples of situations that generally indicate that basis shifts resulting from property distributions are allowable under the anti-abuse provisions:

a. The first example involves a liquidating distribution of appreciated, nonmarketable securities form a partnership without a Section 754 election in place. The distribution resulted in a stepped-up basis in the securities. Because no Section 754 was in place, there was no downward basis adjustment by the amount of untaxed appreciation in the asset distributed. The example acknowledges that the remaining partners will enjoy a timing advantage because the basis of the remaining assets were not adjusted downward. Further, the example provides that the partnership and the liquidating partner had as a principal purpose to take advantage of the basis shift. Notwithstanding the foregoing, the Treasury Regulations conclude this does not violate the anti-abuse provisions.[248]

b. The second example involves a liquidating distribution of an appreciated, non-depreciable asset, and depreciable property with a basis equal to its fair market value. The distribution resulted in a shift of basis from non-depreciable asset to the depreciable asset (adding basis in excess of fair market value). This resulted in additional depreciation deductions and tax benefits to the liquidated partner. The example provides that the partnership and the liquidating partner had as a principal purpose the foregoing tax advantage to the liquidating partner. Notwithstanding the foregoing, the Treasury Regulations conclude this does not violate the anti-abuse provisions.[249]

[247] Treas. Reg. § 1.701-2(c).

[248] Treas. Reg. § 1.701-2(d), Ex. 9.

[249] Treas. Reg. § 1.701-2(d), Ex. 10.

5. The Treasury Regulations do provide an example of an abusive situation. In that example, a partner contributes property with inherent loss to a partnership formed for the purpose by related parties, who contribute cash, used to purchase a nonmarketable security with a value and inside basis equal to the value of the contributed property. The contributor will have a Section 704(c) allocation of the inherent loss and an outside basis equal to the value of the contributed loss property. The property is leased for three years to a prospective purchaser, who has an option to purchase at the value at the time of the contribution. Three years later, but before the sale under the option, the contributor receives a liquidating distribution of the other property with an inside basis equal to the value of the contributed property,[250] but that will have a distributed transferred basis equal to the basis of the contributed property, so that the contributor still has the original inherent loss. The sale by the partnership of the contributed loss property, recognizing the loss after the contributor has withdrawn from the partnership, results in a partnership loss that is allocated to the related partners since the loss that would have been allocated under Section 704(c) of the Code to the contributor is no longer a partner. The Treasury Regulations conclude that this situation is abusive.[251]

6. Notwithstanding the existence of these anti-abuse rules, the IRS may also rely on non-statutory principles like substance-over-form, step-transaction, and sham-transaction doctrines to recast certain partnership transactions.[252]

7. In addition the anti-abuse rules, some mention should be made about the codification of the economic substance doctrine under Section 7701(o) of the Code.[253] It provides, in pertinent part, "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if— the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[254] However, the Code provides an exception for "personal transactions of individuals" and "shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income."[255] It is unclear to what extent this provision could apply to the planning techniques discussed in this outline, particularly since this new paradigm in estate planning combines both transfer tax and income tax planning.

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[250] This transaction might have a different result today. Section 704(c)(1)(C), enacted in the American Jobs Creation Act of 2004, P.L. 108-357, provides that contributed property has a "built-in loss," for purposes of allocating income to other partners, the inside basis will be treated as being equal to its fair market value at the time of contribution.

[251] Treas. Reg. § 1.701-2(d), Ex. 8. *See also* FSA 200242004 (Transfer of loss property to tax partnership, a sale of the partnership interest to unrelated party with no Section §754 election in effect, followed by sale of loss property by the partnership. The transaction was recharacterized under Treas. Reg. § 1.701-2 as sale of assets).

[252] Treas. Reg. § 1.701-2(i).

[253] Health Care and Education Reconciliation Act of 2010, P.L. 111-152, § 1409 (Mar. 30, 2010).

[254] § 7701(o)(1).

[255] § 7701(o)(5)(B).

C. Unitary Basis Rules

1. A partner has a "unitary basis" in his or her partnership interest, even if the partner has different classes of partnership interest (general and limited, preferred and common, etc.) and even if the partner acquired such in different transactions.[256] This is in contrast to the "separate lot" rules applicable to shares of corporate stock when such separate lots can be "adequately identified."[257]

2. Under this unitary basis concept, basis is generally allocated in property to the relative fair market value of different interests when determining such basis allocation is relevant (for example, the sale of a partnership interest or a distribution of property in redemption of a partnership interest). When, however, partnership liabilities exist, changes in a partner's share of debt must be taken into account (deemed distributions and contributions of cash under Section 752 of the Code) in determining basis (corresponding additions or reductions of outside basis under Sections 722 and 733 of the Code).[258]

3. A partner will have a split holding period in his or her partnership interest if the partner acquires his or her partnership interest by contributing assets with different holding periods or by subsequent contributions. The split holding periods are allocated generally in proportion to the fair market value of the property in question.[259]

4. 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.

D. Current and Liquidating Distributions

1. Non-Liquidating "Current" Distributions

a. Cash Distributions

(1) Unless a distribution (or a series of distributions) results in a termination of a partner's interest in a partnership, it will be considered a non-liquidating or "current" distribution.[260] Since most FLPs are structured as "pro rata" partnerships,[261] it is

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

[257] *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.

[258] *See* Treas. Reg. 1.752-1.

[259] *See* Treas. Reg. § 1.1223-3.

[260] Treas. Reg. § 1.761-1(d).

[261] This is generally due to the "same class" exception under § 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, "[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred

important to recognize that, generally, there is no gain or loss on pro rata current distributions regardless of the type of asset being distributed,[262] unless cash distributed exceeds the outside basis of the partnership interest of any of the partners.[263]

(2) Distributions of cash (including a reduction in a partner's share of liabilities and distributions of marketable securities[264]) to a partner reduces the partner's outside basis, with gain recognized to the extent the cash distributed exceeds outside basis.[265] No loss is ever recognized on a current distribution.[266] Any gain resulting from a current distribution of cash is considered capital gain that would result from a sale of the partner's interest.[267] The gain may be ordinary income if the distribution results in a disproportionate sharing of certain "unrealized receivables" and "inventory items" of the partnership (Section 751 assets).[268] The definitions of these types of assets (sometimes referred to as "hot assets") include more things than might be obvious. Unrealized receivables include rights to payment for goods or services not previously included in income,[269] and recapture property, but only to the extent unrealized gain is ordinary income (as discussed above). "Inventory items" include any property described in Section 1221(a)(1) of the Code (inventory or other property held for sale to customers in the ordinary course of business and any other property that would not result in capital gain or gain under Section 1231 of the Code (accounts receivables).

(3) The holding period of any gain from the distribution of cash is determined by the partner's holding period in his or her partnership interest.[270] If the partner acquired his or her partnership interest by contributing property to the partnership (typically in a non-recognition[271] transaction), the holding period of the property transferred is added to the partnership interest's holding period.[272] If the partner acquires the partnership interest at different times, the partnership interest will have different holding periods, allocated in proportion the fair market value of the contributed property.[273]

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interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability)." Treas. Reg. § 25.2701-1(c)(3).

[262] § 731(a)(1) and Treas. Reg. §§ 1.731-1 and 1.732-1(b).

[263] § 731(a)(1) and Treas. Reg. § 1.731-1(a).

[264] § 731(c) and Treas. Reg. § 1.731-2.

[265] § 733(a) and Treas. Reg. § 1.733-1.

[266] §§ 731(a)(2) and 731(b). A loss may only occur with a liquidating distribution. Treas. Reg. §1.731-1(a)(2).

[267] § 731(a).

[268] § 751.

[269] § 751(b) and Treas. Reg. § 1.751-1(b)(2), (d)(1).

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

[271] § 721.

[272] §§ 1223(1), 1223(2) and 723; Treas. Reg. §§ 1.1223-1(b) and 1.723-1.

[273] Treas. Reg. § 1.1223-3(a), (b) and (f), Ex. 1; *See* T.D. 8902, *Capital Gains, Partnership, Subchapter S, and Trust Provisions*, 65 Fed. Reg. 57092 (9/21/00).

b. Property Distributions

(1) Neither the partner nor the partnership will recognize any gain or loss upon a distribution of property,[274] unless the property is a marketable security (treated as cash)[275] or is a "hot asset" under Section 751 of the Code (mentioned above). If the distributed property is subject to indebtedness, any net change (typically an increase) in the partner's share of liability is treated as a contribution (in most cases) or a distribution of cash by the partner, and the distributed property is distributed without recognizing any gain.[276]

(2) The basis of the distributed property in the hands of the partner is based on the tax basis that the partnership had in the property prior to the distribution (the "inside basis").[277] The basis of the distributed property will, however, be limited to the outside basis of the partner's partnership interest, as adjusted for cash distributions (reduction) and changes in liabilities because the distributed property is encumbered with debt.[278] This limitation, effectively, transfers the inherent gain in the partnership interest (outside basis) to the distributed property. When multiple properties are distributed and the outside basis limitation is triggered, the outside basis is allocated first to Section 752 property and any excess to other property.[279] All other distributed property once all outside basis has been exhausted will have a zero basis.

(3) Generally speaking, the character of the distributed property in the hands of the partner will be determined at the partner level, with the exception of unrealized receivables and inventory items, as defined in Section 751 of the Code.[280] This provision prevents a partner from converting an ordinary income item, like inventory in the partnership's hands, into a capital asset. The holding period of the distributed property includes the holding period of the partnership.[281]

c. Partnership Inside Basis

(1) When gain is recognized on a distribution (cash in excess of outside basis) or when the basis of the distributed property is reduced because outside basis is less than the basis of the property prior to the distribution, absent a Section 754 election, there is

[274] § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). Although the "mixing bowl" rules may apply to trigger gain to a partner who contributed the distributed property. §§ 704(c)(2)(B) and 737.

[275] § 731(c) and Treas. Reg. § 1.731-2.

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

[277] § 732(a)(1) and Treas. Reg. § 1.732-1(a). Note, that if a Section 754 election is in place or if the partnership had a substantial built-in loss under Section 743(d) of the Code, the inside basis includes any basis adjustment allocable to the partner under Section 743(b) of the Code but only as they relate to the partner. If the distributed property is not the property that was the subject of the basis adjustment under Section 743(b) of the Code, the adjustment is transferred to the distributed property in the same class (capital gain or ordinary property). Treas. Reg. § 1.755-1(a).

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

[279] § 732(c)(1)(A)(i) and Treas. Reg. §1.732-1(c)(1)(i).

[280] § 735(a).

[281] § 735(b). Note, the holding period of the partner's interest in the partnership is generally irrelevant when determining the holding period of distributed property.

no adjustment to the partnership's inside basis. This gives may give rise to a temporary duplication of gain or to a loss of basis to the partnership (and to the partners).

(a) If a Section 754 election is made, an adjustment of basis under Section 734(b) of the Code occurs when a partner recognizes gain due to a distribution (or deemed distribution) of cash in excess of outside basis, or property is distributed that results in a reduction of basis on the distributed property.[282] The adjustment results in an increase to the inside basis of the partnership asset. The basis increase is allocated among two different classes of assets: (i) capital and Section 1231 assets, and (ii) ordinary income property.[283] Any basis adjustment due to gain from a distribution of cash must be allocated to capital assets.[284] Any increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class in proportion to fair market values.[285] Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners.

2. Liquidating Distributions

a. Liquidating distributions (whether in one distribution or a series of distributions) terminate the liquidated partner's entire interest in a partnership.[286] Liquidating distributions are treated the same as current liquidations except a loss may be recognized,[287] and the basis of property distributed to a partner may be increased (discussed below).[288] The only way to recognize a loss upon a liquidating transfer is if the distribution consists only of cash (but not including marketable securities[289]) and Section 751 assets (hot assets).[290]

b. In the estate planning context, most partnerships are structured as "pro rata" or single class share partnerships because of the "same class" exception under Section 2701(a)(2)(B) of the Code. With respect to this exception, the Treasury Regulations provides, "[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability)."[291] In order to qualify for this exception, it generally requires that distributions must be made proportionately and at the same time (and perhaps with the same assets). In order to effectuate a disproportionate distribution of property to, for example, an older partner with limited outside basis (trying to maximize the benefit of the "step-

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[282] § 734(b)(1).

[283] Treas. Reg. §§ 1.755-1(a)(1) and 1.755-1(c)(1).

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

[285] Treas. Reg. § 1.755-1(c)(1)(i).

[286] § 761(d).

[287] § 731(a)(2) and Treas. Reg. § 1.731-1(a)(2).

[288] § 732(b), 732(c), and Treas. Reg. § 1.732-1(b).

[289] § 731(c)(1) refers to § 731(a)(1), the gain provision, not § 731(a)(2), the loss provision.

[290] § 731(a)(2). Treas. Reg. §§ 1.731-1(a)(2) and 1.732-1(c)(3).

[291] Treas. Reg. § 25.2701-1(c)(3).

up"), one would need to redeem a portion of the partner's interest (lower the percentage ownership), which would be considered a current distribution, or liquidate the partner.

c. When property is distributed in liquidation of a partner's interest, for purposes of determining the basis in the hands of the former partner, the Code provides the basis in Section 751 assets cannot exceed the transferred basis.[292] However, basis of other property distributed can be increased if the liquidated partner's outside basis (reduced by cash distributed and adjusted for any change in the partner's share of liabilities as a result of the distribution) is greater than the inside basis of the assets distributed.[293] If the transferred basis is in excess of the fair market value of the distributed asset, then a loss can be recognized on a subsequent sale or, if the property is depreciable, depletable or amortizable, the added basis can provide tax benefits in the form of ongoing deductions.

d. The basis adjustments to the partnership are the same as discussed with current distributions, in particular, if there is a Section 754 election in place. With respect to liquidating distributions, the inside basis adjustments may be increased or decreased (rather than only increased in a current distribution). This is because a liquidating distribution may result in a loss to the withdrawing partner,[294] and a property distribution may result an increased tax basis.[295] Another difference with liquidating distributions exists when there is a substantial basis reduction. Under Section 734(a), an inside basis adjustment is not required upon a distribution of property to a partner, unless a Section 754 election is in place or unless "there is a substantial basis reduction with respect to such distribution,"[296] which will exist if the amount exceeds $250,000.[297] There will be a substantial basis reduction when the sum of: (i) any loss recognized by the liquidating partner, and (ii) the excess of the basis of distributed property to the liquidated partner over the partnership's transferred inside basis, exceeds $250,000.

e. Adjustments for the gain or loss on the partnership interest, or for distributed capital or Section 1231 assets may be made only to the inside basis of capital or Section 1231 assets, while adjustments to reflect a limitation on the basis of ordinary income property are allocated only to partnership ordinary income property. There may be a positive adjustment for ordinary income assets, and a negative adjustment for capital assets, or the reverse, but no positive adjustment for one capital or ordinary income asset, and negative adjustment for another.[298] Like the adjustments for current distributions, positive adjustments for a class are allocated to appreciated properties, first, in proportion to unrealized gain, and then to all properties in proportion to fair market value.[299] Similarly, reductions in partnership assets are

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[292] § 732(c)(1)(A) and Treas. Reg. § 1.732-1(c)(1)(i).

[293] § 732(b) and Treas. Reg. § 1.732-1(b).

[294] § 734(b)(2)(A) and Treas. Reg. §1.734-1(b).

[295] § 734(b)(2)(B) and Treas. Reg. §1.734-1(b).

[296] § 734(a).

[297] § 734(d). The subsection refers to § 734(b)(2)(A), which in turn refers to §731(a)(2) relating to liquidating distributions, and § 734(b)(2)((B), which refers to § 732(b) also relating to liquidating distribution.

[298] Treas. Reg. § 1.755-1(c)(2).

[299] Treas. Reg. § 1.755-1(c)(2)(i).

allocated first to property that has declined in value in proportion to the unrealized loss, then to all properties in proportion to their adjusted basis.[300]

3. Mixing Bowl Transactions

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

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

(1) If contributed property is distributed within 7 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.[301]

(2) The amount of such gain or loss will generally equal the lesser of (a) the difference between the fair market value of the contributed at the time the property was contributed and the contributing partner's basis in the contributed property, or (b) the difference between the fair market value of the contributed property and the inside basis of the partnership at the time of the distribution.[302] The reason for the latter limitation is the gain or loss is meant to be limited to the amount that would have been allocated to the contributing partner under Section 704(c) of the Code had the partnership sold the asset.

(3) The character of any such gain or loss is determined by the character of the contributed securities in the hands of the partnership.[303]

(4) If the contributed property is exchanged for other property in a tax free exchange, the property received will be treated as the contributed property for the application of Section 704(c)(1)(B) of the Code.[304]

(5) The outside basis of the contributing partner and the inside basis of the contributed property and the "non-contributing" partner (distributee) are adjusted for any gain or loss without the need for a Section 754 election.[305]

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

[301] § 704(c)(1)(B).

[302] § 704(c)(2)(B)(i) and Treas. Reg. § 1.704-4(a).

[303] Treas. Reg. § 1.704-4(b).

[304] Treas. Reg. § 1.704-4(d)(1)(i).

[305] § 704(c)(1)(B)(iii) and Treas. Reg. § 1.704-4(e).

(6) Similar to the general anti-abuse provisions mentioned above, the Treasury Regulations provides that "if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of Section 704(c)(1)(B),"[306] based on all the facts and circumstances, the IRS can recast the transaction appropriately. One example given in the Treasury Regulations deals with a partnership having a nominal outside partner for a number of years, and then prior to the expiration of the (now 7 years) Section 704(c)(1)(B) period, adding a partner to whom it is intended the contributed property will be distributed. When the contributed property is distributed after the "mixing bowl" period has expired, the example provides that a taxable transfer is deemed to have occurred because the "mixing bowl" period is deemed to have been tolled until the admission of the intended recipient partner of the contributed property.[307]

c. Other Property Distributed to Contributing Partner- Section 737

(1) If a partner contributes appreciated property to the partnership and, within 7 years of the date of contribution, that partner receives a distribution of any property <u>other than the contributed property</u>, such partner generally will be required to recognize gain upon the receipt of such other property.[308] The reason for this provision is to avoid deferral of the gain that would have been allocated to the contributing partner under Section 704(c) of the Code because such gain would not be triggered unless the partnership actually sold the property in a taxable transaction. If Section 737 of the Code is triggered, to avoid a doubling of the gain, the subsequent distribution of the property previously contributed by the same partner does not trigger gain.[309]

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

(3) The amount of the gain is equal to the lesser of (a) "net precontribution gain"[310] (aggregate net gain, as reduced by any loss property, that would be realized under Section 704(c)(1)(B) if all of the property contributed by the contributor within 7 years of the distribution (and still owned by the partnership) had been distributed to another partner;[311] (b) the excess of the fair market value of the distributed property over the outside basis of the partnership interest, determined with adjustments resulting from the distribution without regard to the gain triggered by Section 737 of the Code.[312]

(4) The character of the gain is determined by reference to the "proportionate character of the net precontribution gain,"[313] which is to say, it is generally determined by its character in the hands of the partnership.

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[306] Treas. Reg. § 1.704-4(f)(1).

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

[308] §§ 704(c)(1)(B) and 737.

[309] § 737(d)(1) and Treas. Reg. § 1.737-3(d).

[310] § 737(b).

[311] *See* Treas. Reg. §§ 1.737-1(c)(1)(iv) and 1.737-1(e), Ex. 2.

[312] §§ 737(a)(1) and (2).

[313] § 737(a) [flush language] and Treas. Reg. § 1.737-1(d).

(5) The partner's outside basis and the partnership's inside basis in the contributed property are automatically adjusted without the need for a Section 754 election.[314] Further, the basis of the distributed property is adjusted to reflect the recognized gain on the partner's outside basis.[315]

(6) Marketable securities are generally treated as cash for purposes of Section 737 of the Code.[316] In determining "net precontribution gain" under Section 737, however, marketable securities contributed to the partnership are treated as contributed property.[317]

(7) Similar to the anti-abuse guidelines under Section 704(c)(1)(B) of the Code, the Treasury Regulations provide that transactions can be recast if, based on all the facts and circumstances, they are "inconsistent with the purposes of Section 737."[318] The deemed abusive example provided in the Treasury Regulations provides involves a transaction, in an intentional plan to avoid Section 737 of the Code, where a there is a contribution of property to a partnership (under Section 721 of the Code) immediately before a distribution of other property to the contributing partner (who also made a previous contribution of appreciated property). Gain under Section 737 would be avoided because the contribution increased the outside basis of the contributing partner. Then the partnership liquidates the contributing partner's interest in a nontaxable distribution, returning the contributed property (temporarily parked in the partnership to avoid gain on the distribution of other property prior to the liquidation of the partner's interest).[319]

4. Disguised Sale Rules

a. If a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash within 2 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.[320]

b. Distributions within two years are presumed to be part of a disguised sale, and those more than two years are presumed not to be part of a disguised sale.[321]

c. Distributions in a transaction determined to be a disguised sale are treated as payments by the partnership to the disguised seller-partner, acting in an independent capacity, and not as a partner.[322]

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[314] § 737(c) and Treas. Reg. § 1.737-3. The increase in inside basis is allocated to property with unrealized gain of the same character as the gain recognized. *See* Treas. Reg. §§ 1.737-3(c)(3) and 1.737-3(e), Ex. 3.

[315] § 737(c)(1) and Treas. Reg. § 1.737-3(b)(1).

[316] §§ 737(c)(1), 737(e), and Treas. Reg. § 1.731-2(a).

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

[318] Treas. Reg. § 1.731-4(a).

[319] Treas. Reg. § 1.731-4(b), Ex. 1.

[320] § 707(a)(2)(B).

[321] Treas. Reg. § 1.707-3.

[322] § 707(a)(2) and Treas. Reg. § 1.707-3.

5. Distributions of Securities

a. A distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property).[323] For these purposes, marketable securities includes financial instruments (stocks, equity interests, debt, options, forward or futures contracts, notional principal contracts and other derivatives) and foreign currencies which are actively traded.[324]

b. There are a number of applicable exceptions to the foregoing treatment of distributions of marketable securities, including: (1) distributions of contributed securities to the partner who contributed them;[325] (2) distributions of securities that were not marketable when acquired by the partnership;[326] and (3) distributions of securities from an "investment partnership" to an "eligible partner."[327]

c. An "investment partnership" is defined as a partnership that substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.[328] Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).[329] A partnership will not be considered engaged in a trade or business by reason of any activity undertaken as an investor, trader, or dealer in such specified investments.[330]

d. An "eligible partner" is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.[331]

e. If one of these exceptions do not apply and a distribution of marketable securities my result in gain to the distribute partner to the extent the value of the marketable securities exceeds outside basis.[332] The amount of marketable securities treated as cash is reduced (and the potential recognized gain is reduced) by:

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[323] § 731(c).

[324] § 731(c)(2)(A) and (C).

[325] § 731(c)(3)(A) and Treas. Reg. § 1.731-2(d)(1).

[326] § 731(c)(3)(A)(ii) and Treas. Reg. § 1.731-2(d)(1)(iii). To qualify for this exception, the security must not have been marketable on the date acquired and the entity to which the security relates must not have had any outstanding marketable securities on that date. Further, the hedge fund must have held the security for at least 6 months prior to the security becoming marketable, and the hedge fund must distribute the security within 5 years from the date the security became marketable.

[327] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

[328] § 731(c)(3)(C)(i).

[329] § 731(c)(3)(C)(i)(I) through (VIII).

[330] § 731(c)(3)(C)(ii)(I) and Treas. Reg. § 1.731-2(e)(3)(i).

[331] § 731(c)(3)(C)(iii)(I).

[332] § 731(c)(3)(B) and Treas. Reg. § 1.731-2(a) and (j), Ex. 1.

(1) "such partner's distributive share of the net gain which would be recognized if all of the marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, over;"[333]

(2) "such partner's distributive share of the net gain which is attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the transaction, determined by using the same fair market value."[334]

f. Any unrealized loss in the marketable securities is not recognized, either by the partnership or the partner.[335]

g. If gain is recognized on the distribution of marketable securities under Section 731(c) of the Code, the tax basis of the distributed securities is increased by the amount of such gain, allocated to the distributed securities in proportion to unrealized appreciation.[336] If no gain is recognized, the basis of the marketable securities in the hands of the partner is the inside basis under the general rule of Section 732 of the Code. It's important to keep in mind that Section 731(c) of the Code applies only for purposes of determining gain to the partner. The partner's outside basis is still determined under the general rules of Section 733 of the Code. As such, when gain is recognized upon a distribution of marketable securities, the partner's outside basis, by definition, is reduced to zero. Any gain recognized by the partner is not reflected in the partner's outside basis, rather it is reflected in the securities received.

h. If the partner receives other property in addition to marketable securities in the same distribution, the reduction in outside basis due to the marketable securities (cash) is taken into account first, with any remaining basis applied against the other property distributed.[337]

i. Even if a Section 754 election is in place, any gain triggered from a distribution of marketable securities will not be reflected in the inside basis of any other partnership property. However, if a Section 754 election is in place, the inside basis of partnership can be adjusted for any lost basis resulting from the limitation of the basis of the marketable securities in the partner's hands to the partner's outside basis (because outside basis is not adjusted to reflect the gain, as mentioned above).[338]

E. Partnership Liabilities and Basis

1. The partnership rules make an important distinction between recourse and nonrecourse liabilities. In this context, generally, recourse liabilities increase basis only as to the

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[333] § 731(c)(3)(B)(i).

[334] § 731(c)(3)(B)(ii),

[335] § 731(b).

[336] § 731(c)(4) and Treas. Reg. § 1.731-2(f)(1)(i).

[337] § 731(a)(1) and Treas. Reg. § 1.731-2(f)(1)(ii), (j), Ex. 5.

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

partner who bears economic risk of loss, whereas nonrecourse liabilities increase basis proportionately among all of the partners. A partnership liability is considered recourse if any partner or "related person" bear the economic risk of loss for the liability.[339] Conversely, a liability is considered nonrecourse to the extent no person or "related person" bears such risk of loss.[340]

2. Any increase in a partner's share of liabilities (including any assumption by a partner of any partnership liabilities) is treated as contribution of cash by the partner in the partnership, thereby increasing basis.[341] Any decrease is treated as a distribution of cash to the partner, thereby reducing basis and possibly resulting in the recognition of gain if the amount of the deemed distribution exceeds available outside basis.[342] If property that is subject to a liability is contributed to or distributed from a partnership, the transferee is deemed to assume the liability but only to the extent the liability is not in excess of the fair market value.[343]

3. A partner or related person will be deemed to bear the economic risk of loss for a partnership liability if the partner or related person would be obligated to make a payment to any person (like a third-party lender) or a contribution to the partnership upon a constructive liquidation of the partnership.[344] Whether such payment or contribution obligation exists (and the extent of such obligation) depends on all the facts and circumstances, like the existence of the following:

a. Contractual obligations like "guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;"[345]

b. Partnership obligations including "obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership;"[346]

c. Payment obligations "imposed by state law, including the governing state partnership statute;"[347] and

d. Reimbursement rights a partner or related person may have from another partner or a person who is related to such other partner.[348]

4. In making a determination of whether a partner or related person has a payment obligation on a partnership liability and bears the economic risk of loss, it is assumed

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[339] Treas. Reg. § 1.752-1(a)(1).

[340] Treas. Reg. § 1.752-1(a)(2).

[341] § 722 and Treas. Reg. § 1.752-1(b).

[342] §§ 733, 731(a), 751 and Treas. Reg. § 1.752-1(c).

[343] Treas. Reg. § 1.752-1(e).

[344] Treas. Reg. § 1.752-2(b)(1)

[345] Treas. Reg. § 1.752-2(b)(3)(i).

[346] Treas. Reg. § 1.752-2(b)(3)(ii).

[347] Treas. Reg. § 1.752-2(b)(3)(iii).

[348] Treas. Reg. § 1.752-2(b)(5).

the partner or related person will be able to pay the obligations "irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation."[349]

5. The Treasury Regulations define a person will be a "related person" to a partner if they have a relationship that is specified in Sections 267(b) and 707(b)(1) of the Code but with a few modifications.[350] Including those modifications, a person is related to a partner if they are (in part):

a. Members of the same family (spouse, ancestors and lineal descendants);

b. An individual and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for such individual;

c. A grantor and a fiduciary of any trust;

d. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

e. A fiduciary of a trust and a beneficiary of such trust;

f. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

g. A fiduciary of a trust and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

h. A person and a charitable organization if the organization is controlled directly or indirectly by such person or, if the person is an individual, by members of the individual's family;

i. A corporation and a partnership if the same persons own more than 80% in value of the outstanding stock of the corporation and more than 80% of the capital interest or the profits interest in the partnership;

j. An S corporation and another S corporation (or C corporation) if the same persons own more than 80% in value of the outstanding stock of each corporation;

k. Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of that estate;

l. A partnership and a person owning, directly or indirectly, more than 80% of the capital interest, or the profits interest, in such partnership; or

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[349] Treas. Reg. § 1.752-2(b)(6).

[350] Treas. Reg. § 1.752-4(b)(1).

m. Two partnerships in which the same persons own, directly or indirectly, more than 80% of the capital interests or profits interests.

6. To avoid double counting, the Treasury Regulations provide that persons owning interests (directly or indirectly) in the same partnership are not treated as related persons for purposes of determining their share of partnership loss.[351]

7. The Treasury Regulations further provide that if (i) a partnership liability is held or guaranteed by another entity that is a partnership, S corporation, C corporation, or trust; (ii) a partner or related person (directly or indirectly) owns 20% or more in such other entity, and (iii) a principal purpose of having such other entity act as a lender or guarantor is to avoid having the partner bears the risk of loss for all or part of the liability, then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of that partner's or related person's ownership interest in such other entity.[352] The ownership interest of the partner and related person are determined according to each entity in the following manner:

a. Partnership: highest percentage interest in any partnership loss or deduction for any taxable year;[353]

b. S corporation: percentage of outstanding stock owned by the shareholder;[354]

c. C corporation: percentage of the issued and outstanding stock owned by the shareholder based upon fair market value;[355] and

d. Trust: actuarial percentage interest owned beneficially.[356]

8. An otherwise nonrecourse partnership liability is treated as a recourse liability to the extent that a partner or a related person holds an interest in the liability, referred to as "partner nonrecourse debt" in the Treasury Regulations.[357] In such case, the economic risk of loss is allocated to such partner (or related person) to the extent not otherwise allocated to another partner.[358]

9. If a partner (or related person) pledges property outside the partnership (a direct pledge) as security for a partnership liability, the partner is deemed to bear the risk of loss to the extent of the "net fair market value" of the pledged property.[359] If a partner contributes property to a partnership solely for the purpose of securing a partnership liability (an indirect

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[351] Treas. Reg. § 1.752-4(b)(2)(iii).

[352] Treas. Reg. § 1.752-4(b)(2)(iv)(A).

[353] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(1)

[354] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(2).

[355] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(3).

[356] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(4).

[357] *See* Treas. Reg. § 1.704-2(b)(4).

[358] Treas. Reg. § 1.752-2(c)(1).

[359] Treas. Reg. § 1.752-2(h)(1).

pledge), the partner is deemed to bear the risk of loss to the extent of the "net fair market value" of the pledged property.[360] Contributed property will not be deemed indirectly pledged unless "substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction."[361]

10. As with other partnership provisions, the Treasury Regulations contain anti-abuse rules that would disregard the form of the situation "if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise."[362] The Treasury Regulations discuss 2 situations:

a. Arrangements tantamount to a guarantee:[363]

(1) Partner or related person undertakes one or more contractual obligations so the partnership may obtain a loan;

(2) Contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and

(3) One of the principal purposes is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

b. A plan to circumvent or avoid the obligation, based on the facts and circumstances, of a partner (or related person).[364]

11. A complete discussion of how nonrecourse liabilities are shared by partners is beyond the scope of this outline, but the Treasury Regulations generally provide that a partner's share of such liabilities are the sum of:[365]

a. The partner's share of "partnership minimum gain"[366] (gain that would be realized if all property subject to nonrecourse liability is sold in full satisfaction of the liabilities and for no other consideration);[367]

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[360] Treas. Reg. § 1.752-2(h)(2).

[361] *Id.*

[362] Treas. Reg. § 1.752-2(j)(1).

[363] Treas. Reg. § 1.752-2(j)(2). *See* CCA 200246014 (a guarantee was disregarded due to a number of facts including sever undercapitalization and the provisions of the guarantee set forth many waivers and defenses for the benefit of the purported guarantor).

[364] Treas. Reg. § 1.752-2(j)(3). An example is provided that involved a general partnership, minimally capitalized corporation as a partner and a deficit capital account restoration obligation. The obligations of the corporate partner and the capital account restoration obligation are ignored for purposes of Section 752 of the Code.

[365] Sometimes referred to as the sum of tier one, tier two, and tier three allocations.

[366] Treas. Reg. § 1.752-2(d)(1).

b. Amount of taxable gain that would be allocated to the partner under Section 704(c) (arising because the partner contributed property to the partnership and the partnership still holds the property) if the partnership disposed of all partnership property subject to nonrecourse liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration;[368] and

c. The partner's share of "excess nonrecourse liabilities" (liabilities not allocated above).[369]

A partner's share of "excess nonrecourse liabilities" is "determined in accordance with the partner's share of partnership profits" under all of the "facts and circumstances relating to the economic arrangement of the partners."[370] As a result, if an FLP has pro rata shares (as is common), and no partner has made a contribution of property to the partnership, then nonrecourse debt will also be shared pro rata.

F. Section 754 Election and Inside Basis Adjustments

1. General

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

b. Generally, the inside basis of partnership assets are not adjusted when a partnership interest is sold or exchanged, when a partner dies or when there is a distribution of property to a partners. These transactions can create discrepancies between inside and outside basis, which in turn can create distortions in the amount of income recognized and the timing of the income. For example, if a partner dies or a partner sells his or her partnership interest, the transferee partner of will have a basis in the partnership interest equal to fair market value or the cost of the sale. If that basis is greater than the inside basis of the assets, when the partnership sells those assets, additional gain will be allocated to the transferee partner. Similarly, if a partnership makes a liquidating distribution to a partner for cash, and the partner recognizes gain as a result of that distribution because the partner's outside basis is less than the cash distributed, that gain essentially represents the liquidated partner's share of appreciation in the partnership. Absent an adjustment to inside basis, a subsequent sale of the partnership assets will result in that gain being allocated to the remaining partners. The adjustments under Sections 743 and 734 of the Code attempt to adjust for those types of discrepancies. Adjustments can increase or decrease the inside basis of partnership property.

2. A Section 754 election is generally made by the partnership in a written statement filed with the partnership return for the taxable year during which the transfer in

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[367] Treas. Reg. § 1.752-3(a)(1).

[368] Treas. Reg. § 1.752-3(a)(2).

[369] Treas. Reg. § 1.752-3(a)(3).

[370] *Id.*

question (sale, exchange, death or distribution) occurs.[371] Once the election is made, it applies to the year for which it is filed as well as all subsequent taxable years until and unless it is formally revoked.[372]

3. The adjustments under Sections 743(b) of the Code is mandatory even in the absence of a Section 754 election if the partnership has a substantial built-in loss immediately after the sale or exchange or upon death (adjustment under Section 743(b) of the Code) or there is a substantial basis reduction with respect to a distribution (adjustment under Section 734(b) of the Code).

(1) There is a substantial built-in loss if the partnership's inside basis on all partnership property exceeds the fair market value by more than $250,000.[373]

(2) There is a substantial basis reduction resulting from a distribution of property if the sum of the follow exceeds $250,000: (i) a loss to the partner (only upon a liquidating transfer, as discussed above); and (ii) excess basis of the distributed property in the hands of the partner over the inside basis prior to the distribution.[374]

4. Adjustments under Section 743(b) of the Code result in either:

a. An increase in the transferee's share of partnership inside basis "by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property"[375] or

b. A decrease in the transferee's share of partnership inside basis "by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership."[376]

5. A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities.[377] The partner's previously taxed capital is:[378]

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

[372] § 754 and Treas. Reg. § 1.754-1(a). An election may be revoked if there exists: (i) a change in the nature of the partnership business; (ii) a substantial increase in or a change in the character of the partnership's assets; and (iii) an increase in the frequency of partner retirements or shifts in partnership interests (resulting in increased administrative costs attributable to the § 754 election). Treas. Reg. § 1.754-1(c)(1).

[373] § 743(d)(1).

[374] § 734(b)(2) and (d).

[375] § 734(b)(1).

[376] § 734(b)(2).

[377] Treas. Reg. § 1.743-1(d)(1).

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

a. The amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets[379]; increased by

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

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

6. The inside basis adjustment under Section 743(b) of the Code is then allocated among the partnership property under the rules set out in Section 755 of the Code.

a. Generally, Section 755 of the Code seeks to reduce the difference between the fair market value of partnership assets and the adjusted tax basis of the partnership in such assets.[380]

b. In allocating the adjustment, to the extent the adjustment is attributable to property consisting of (i) capital assets and Section 1231(b) property (capital gain property) and (ii) any other property, the adjustment must be allocated to partnership property of a like character (ordinary income property).[381]

c. The adjustment is allocated first between the capital gain property and ordinary income property, and then is allocated among the assets within these two asset categories.[382]

G. Partnership Divisions

1. Generally

a. Divisions of partnerships are generally not specifically defined in the Code or under state law. A partnership division is any transaction that converts a single partnership into two or more resulting partnerships. A division of a partnership can be accomplished in a number of different ways, sometimes referred to as, "assets-over, assets-up, and interests-over."[383]

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

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[379] Treas. Reg. § 1.743-1(d)(2).

[380] § 755(a).

[381] § 755(b).

[382] Treas. Reg. § 1.755-1(a)(1).

[383] Cassady V. Brewer, *Coming Together and Breaking Apart: Planning and Pitfalls in Partnership Mergers and Divisions*, 43rd Annual Southern Federal Tax Institute (2008), Outline F, F-13.

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

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

b. To avoid unintended transfer tax consequences, tax planners must be wary of the special valuation rules of Chapter 14, in particular, Section 2701 of the Code.

(1) Section 2701 includes a "transfer" of an interest in a family-controlled partnership to a member of the transferor's family, pursuant to which the transferor keeps an applicable retained interest.[384] "Transfer" is broadly defined and is deemed to include "a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership."[385]

(2) Importantly in this context, Section 2701 of the Code does not apply to a transfer "to the extent the transfer by the individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer."[386] The Treasury Regulations provide the following example: "Section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate by 10 percent even if the transfer does not proportionately reduce P's interest in each class."[387] This exception is often referred to as the "vertical slice exception."

(3) In addition, Section 2701 of the Code does not apply to any right with respect to an applicable retained interest if such interest is the same class as the transferred interest,[388] or the same as the transferred interest, without regard to non-lapsing differences in voting power (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).[389]

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

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[384] § 2701.

[385] § 2701(e)(5).

[386] Treas. Reg. § 25.2701-1(c)(4).

[387] *Id.*

[388] § 2701(a)(2)(B).

[389] § 2701(a)(2)(C). Non-lapsing provisions that are necessary to comply with the partnership allocation requirements of the Code will be treated as non-lapsing differences with respect to limitations on liability. Treas. Reg. § 25.2701-1(c)(3).

2. Tax Treatment of Partnership Divisions

a. Partnership divisions are governed by section 708(b)(2)(B) of the Code. The Treasury Regulations issued in 2001,[390] provide that the IRS will not respect the "interests-over" form of partnership division described above. In addition, while both an assets-over and assets-up method will be respect the Treasury Regulations, there is a preference to treat the transaction as an assets-over transaction.[391]

b. In the assets-over form, the divided partnership transfers assets to the recipient partnership in exchange for interest in the recipient partnership, followed by a distribution of the recipient partnership interests to the partners.[392] Parity of ownership interests will likely exist between the divided partnership and the recipient partnership because of the Chapter 14 considerations mentioned above. As such, the distribution of the recipient partnership interest to the partners will be current distributions rather than liquidating distribution because no partner is terminating his or her interest in the divided partnership. Because of this parity of ownership, it is unlikely that the "mixing bowl" transaction (as discussed above) will trigger any gain or loss.[393] Furthermore the preamble to the Treasury Regulations point out that when a division results in a pro rata division, there are no Section 704(c) implications.[394] Similarly, given the parity of ownership before and after the division, there should be no gain resulting from a deemed distribution of cash under Section 752 of the Code because the division will not result in a change in the share of the liabilities of the partners.

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

d. In a division, the Treasury Regulations provide that a "resulting partnership"[395] (a partnership that has at least 2 partners from the prior partnership) will be considered a continuation of the prior partnership if the partners in the resulting partnership had an interest of more than 50 percent in the capital and profits of the prior partnership.[396] All resulting partnerships that are considered a continuation of the prior partnership are subject to all preexisting tax elections (for example, a Section 754 election) that were made by the prior partnership.[397] Thus, in pro rata divisions where all of the partners retain the same ownership in the resulting partnerships, all of the resulting partnerships will be considered continuing partnerships, retaining all prior tax elections of the divided partnership.[398]

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[390] T.D. 8925, 66 Fed. Reg. 715 (1/4/01).

[391] *See* Treas. Reg. § 1.708-1(d)(3).

[392] Treas. Reg. § 1.708-1(d)(3)(i)(A). The transitory ownership by the divided partnership of all the interests in the recipient partnership is ignored. Treas. Reg. § 1.708-1(d)(5) Ex. 3-6.

[393] §§ 704(c)(1)(B), 737 and Treas. Reg. §§ 1.704-4(c)(4), 1.737-2(b)(2).

[394] T.D. 8925, 66 Fed. Reg. 715 (1/4/01). Non-pro rata divisions are still being reviewed.

[395] Treas. Reg. § 1.708-1(d)(4)(iv)

[396] Treas. Reg. § 1.708-1(d)(1).

[397] Treas. Reg. § 1.708-1(d)(2)(ii).

[398] *See* PLR 9015016 (seven continuing partnerships with same owners in the same proportions).

e. There is a narrow anti-abuse provision in the Treasury Regulations with respect to partnership divisions. It provides that if a partnership division is "part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent"[399] with the form, the IRS may recast the larger series of transactions in accordance with their substance.

3. Partnership Divisions in Tax Basis Management

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

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

H. Death of a Partner

1. Generally

a. The transfer of a deceased partner's interest in a partnership will not result in gain or loss, even if the deceased partner's share of liabilities exceeds outside basis.[400]

b. The decedent's outside basis in the partnership will equal the fair market value of the partnership interest for estate tax purposes (which is net of partnership liabilities), plus the estate's share of partnership liabilities, minus any value attributed to items of IRD owned by the partnership. The Treasury Regulations provide, "The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706-1 and paragraph (b) of § 1.753-1) under section 691."[401]

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[399] Treas. Reg. § 1.708-1(d)(6). *See also* Treas. Reg. § 1.708-1(c)(6)(ii) for an example of an abusive series of transactions that involved a partnership division and merger.

[400] *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995).

[401] Treas. Reg. § 1.742-1.

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

2. Inside Basis Adjustments at Death

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

(1) The inside basis adjustment in basis will not, however, "step-up" the basis of partnership assets that would be considered IRD if held by the deceased partner individually and unrealized receivables of the partnership.[402]

(2) The IRS has affirmatively ruled that the inside basis adjustment applies to the entire partnership interest that is considered community property upon the death of the deceased spouse/partner.[403]

(3) The inside basis adjustment is limited by the fair market value of the deceased partner's interest in the partnership. As such, to the extent that valuation discounts are applicable to the partnership interest, the inside basis adjustment will be limited to the extent of such discounts. To the extent little or no transfer taxes would be payable upon the death of a partner, practitioners may want to reduce or eliminate such valuation discounts, thereby maximizing the inside basis adjustment with a Section 754 election. Further, because the inside basis adjustment under Section 743 of the Code is applied to all of the assets in the partnership at the time of the death of the partner, the adjustment does not allow tax practitioner to proactively choose which asset will get the benefit of the "step-up" in basis. For this reason, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner's death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply, and if the partner's outside basis is very low, the distributed property will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the "step-up" in basis and also choose the asset that they wish to receive the basis adjustment at death.

(4) As mentioned above, the adjustment under Section 743(b) of the Code is the difference between the successor partner's tax basis in partnership interest (generally, fair market value at the date of death under Section 1014(a) of the Code, increased by the partner's share of partnership liabilities and reduced by items of IRD) and the successor partner's proportionate share of the basis of the partnership property. In calculating the partner's proportionate share of the partnership's tax basis, the Treasury Regulations assume a fully taxable hypothetical sale of the partnership's assets. This taxable sale is deemed to occur immediately after the transfer that triggers the inside basis adjustment. The IRS has ruled that the transfer in question, for purposes of Section 743(b), is the date of the decedent partner's death.[404]

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[402] §§ 1014(c), 691(a)(1), Treas. Reg. § 1.691(a)(1)-1(b), and *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972).

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

[404] Rev. Rul. 79-84, 1979-1 C.B. 223 (partnership interest owned by grantor trust).

As such, practitioners should consider what effect the death of the partner might have on the value of the partnership assets in determining the inside basis adjustment.

b. As mentioned above, even absent a Section 754 election, there is a mandatory downward inside basis adjustment if, at the time of death, the partnership as a substantial built-in loss (more than $250,000).[405]

c. In addition, even with no Section 754 election, the estate or successor in interest can achieve the same benefits of an inside basis adjustment if the partnership makes a liquidating distribution of property within 2 years of the date of death and if the successor partner makes an election under Section 732(d) of the Code.[406]

I. Family Partnership Examples

1. Example 1: Indemnifications and Divisions

a. The following hypothetical illustrates how easily partnerships can facilitate tax basis management in fairly typical estate-planning scenarios. The facts are as follows:

(1) Assume that Mr. and Mrs. Developer are married with three adult children. Exclusive of their home, vacation home, and other personal use assets, Mr. and Mrs. Developer have a net worth of approximately $25 million. Most of Mr. and Mrs. Developer's wealth derives from constructing, owning, and leasing "General Dollar" stores across Georgia, a state that does not have a state death tax. All of the General Dollar store properties are held by General Dollar Lessor, LLC, which is a wholly owned subsidiary of Mr. and Mrs. Developer's family partnership, "Developer Family Partnership, LLLP" (hereinafter "FLLLP"). Assume General Dollar Lessor, LLC has no assets other than the General Dollar stores that it owns and leases. FLLLP was formed many years ago to be the family "holding company."[407]

(2) General Dollar Lessor, LLC has a gross fair market value of approximately $31 million subject to recourse debt of $10 million which is secured by all of its assets (for a net value of $21 million). The debt also is personally guaranteed by Mr. Developer. Due to depreciation and past like-kind exchanges, the adjusted basis of the assets held by General Dollar Lessor, LLC is only $10 million.

(3) FLLLP owns $9 million in publicly-traded securities in addition to its ownership of 100% of General Dollar Lessor, LLC. Essentially, the $9 million in publicly traded securities was accumulated by investing cash flow and earnings distributed to FLLLP from General Dollar Lessor, LLC. In turn, FLLLP would distribute some of the cash flow and earnings to its partners (especially for them to pay taxes), but FLLLP would retain and invest any amounts not distributed to its partners. The aggregate adjusted basis of the FLLLP in the

[405] § 743(b).

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

[407] If FLLLP has been in existence for more than seven years, and no appreciated or depreciated property has been contributed to the FLLLP by the partners within the past seven years, then the FLLLP will avoid the "mixing bowl" and "disguised sale" rules of §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b) of the Code. *See* above for further discussion of these rules.

publicly-traded securities is $6 million. A significant portion of the securities have bases equal to their face values (e.g., bonds).

(4) The aggregate outside bases of the partners of FLLLP in their partnership interests is $16 million. The ownership of FLLLP is split roughly 70% to Mr. Developer and 30% to his three adult children as follows:

(a) Mr. and Mrs. Developer own 50% each in FLLLP GP, LLC, which in turn owns a 1% general partner interest in FLLLP. The outside basis of FLLLP GP, LLC in its GP interest in FLLLP is $203,000 (rounded). The non-discounted value of FLLLP GP, LLC's 1% GP interest in FLLLP is $300,000.

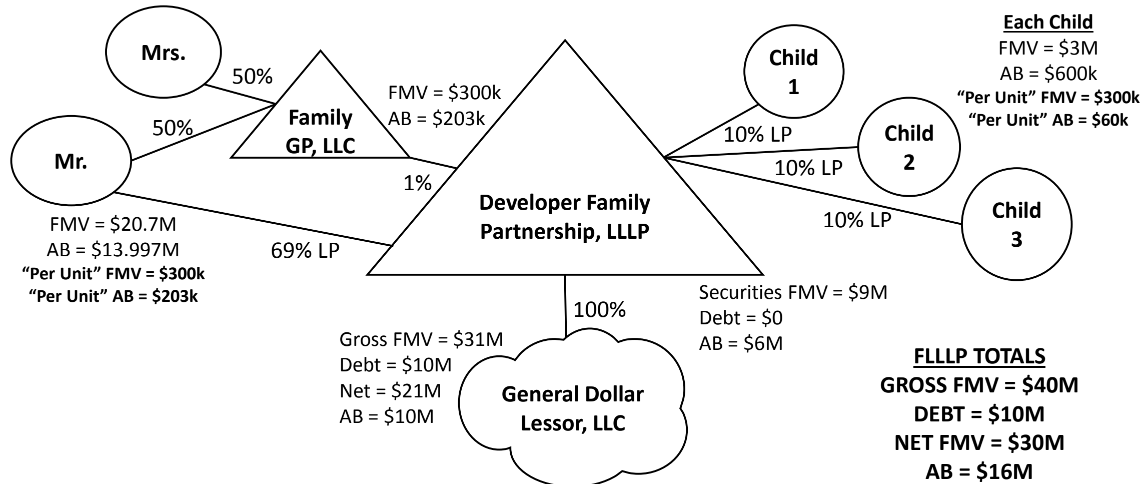
(b) Mr. Developer owns 69 limited partner "LP Units." These LP Units correspond to an aggregate 69% interest in FLLLP (1% per LP Unit). Mr. Developer's LP Units have a total outside basis of $13,997,000 (rounded) and a non-discounted value of $20,700,000.

(c) Each adult child owns 10 LP Units (corresponding to a 10% interest in FLLLP for each child). Each child's outside basis in his/her LP Units is $600,000 and the non-discounted value of each child's 10 LP Units is $3 million, respectively.

(5) Mr. and Mrs. Developer have their full $10.68 million applicable credit available and have a basic estate plan that leaves all of their assets to their three adult children and their families.

(6) A diagram of the FLLLP ownership structure is set forth below. In the diagram, individuals are represented by circles, partnerships (including entities treated as partnerships for income tax purposes) are represented by triangles, and disregarded entities are represented as clouds:

Family Partnership Hypothetical



(7) Based upon the foregoing facts, the capital accounts and bases of Mr. and Mrs. Developer and their children in their partnership interests (their "outside bases") in FLLLP are as follows:[408]

	Developer (Includes Family GP, LLC)			Children		
	Capital Accounts	Outside Basis	Fair Market Value	Capital Acounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000

b. Pursuant to the Treasury Regulations,[409] the $10 million debt of General Dollar Lessor, LLC is treated as "partner nonrecourse debt" with respect to Mr. Developer. The debt is treated as "partner nonrecourse debt" because it is guaranteed by Mr. Developer, and he therefore bears the economic risk of loss with respect to the loan if (as one is required to assume under the Treasury Regulations) General Dollar Lessor, LLC's assets became worthless and the liability became due. Accordingly, the debt of General Dollar Lessor, LLC is treated as recourse to Mr. Developer.[410] Therefore, the entire $10 million of the liability is allocated to Mr. Developer for purposes of determining his outside basis in FLLLP.[411] This is why Mr. Developer's aggregate outside basis in FLLLP ($14.2 million) is disproportionately higher than the aggregate outside basis ($1.8 million) of the children in FLLLP.

[408] *See* Treas. Reg. § 1.704-1(b)(2)(iv) for the rules regarding the maintenance of capital accounts for partners in a partnership. *See* § 705 and the Treasury Regulations thereunder for the rules regarding the determination of a partner's basis in his or her partnership interest. For the sake of simplicity, the capital accounts and outside bases of Mr. and Mrs. Developer and the children are aggregated here (including, of course, the capital accounts and outside bases of Mr. and Mrs. Developer held through Family GP, LLC).

[409] Treas. Reg. § 1.704-2(b)(4).

[410] Treas. Reg. § 1.752-1(a)(1).

[411] *See* Treas. Reg. § 1.752-2.

c. Assume that Mrs. Developer predeceases Mr. Developer and leaves all of her assets to him. Next, Mr. Developer dies leaving all of his partnership interests in FLLLP to his three adult children in equal shares. Further assume for this purpose that Mr. Developer's combined[412] partnership interests in FLLLP have a non-discounted value of $20 million. If Mr. Developer's combined partnership interests in FLLLP are discounted by 25% for estate tax purposes, then their value will be $15 million (75% of $20 million). This discounted estate-tax value results in very little step-up in outside basis in the FLLLP as compared to Mr. Developer pre-death outside basis of $14.2 million.

d. On the other hand, if prior to his death Mr. Developer's children had indemnified Mr. Developer for 30% (i.e., their combined percentage share of FLLLP) of any liability on the $10 million debt of General Dollar Lessor, LLC, then the outside bases of Mr. Developer and his children in FLLLP would have been as reflected in the table below:

	Developer (Includes Family GP, LLC)			Children		
	Capital Accounts	Outside Basis	Fair Market Value	Capital Acounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000
Children Indemnify 30% Debt		($3,000,000)			$3,000,000	
TOTALS	$4,200,000	$11,200,000	$21,000,000	$1,800,000	$4,800,000	$9,000,000

(1) Under the Treasury Regulations,[413] this simple step of indemnifying Mr. Developer for 30% of the $10 million debt—a step contemplated by the Treasury Regulations[414]—would shift a debt allocation of $3 million of the $10 million General Dollar Lessor, LLC debt to the children.[415]

(2) This shift would not change the percentage interests of the partners or the values of their partnership interests. As noted above, though, it clearly would increase by $3 million the amount of the potential basis step-up to Mr. Developer's estate upon his death even after taking into account the estate-tax valuation discount on Mr. Developer's partnership interests in FLLLP.

e. Moreover, proactive tax basis management could be taken a step further if, prior to Mr. Developer's death, the FLLLP implemented a "vertical slice" partnership division under Section 708(b)(2)(B) of the Code (an "assets-over" transaction, as discussed

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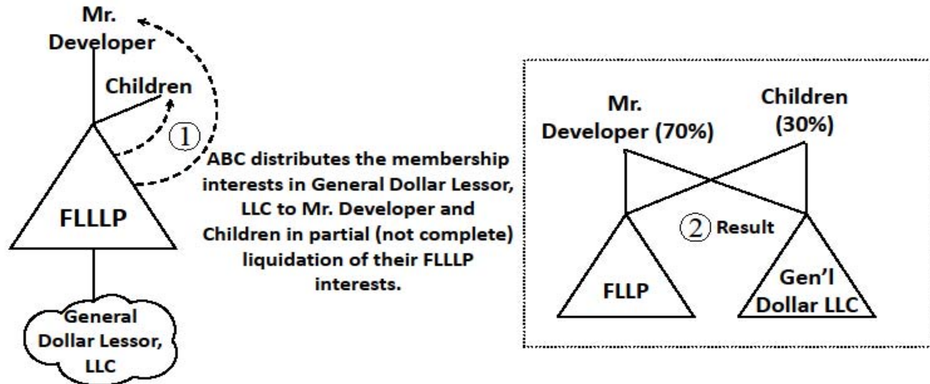
[412] That is, his 69% limited partner interest held directly in FLLLP and his 1% general partner interest held through Family GP, LLC.

[413] Treas. Reg. §§ 1.752-1(a)(1) and 1.752-2.

[414] *See* Treas. Reg. § 1.752-2(b)(3) (stating that contractual obligations "such as . . . indemnifications" outside the partnership agreement are to be taken into account in determining the partners' economic risk of loss and shares of liabilities for outside basis purposes).

[415] Technically, under §§ 752(a) and (b) of the Code, this shift in the allocation of the $10 million debt of General Dollar Lessor, LLC is treated as a constructive distribution of cash to Mr. Developer and a constructive contribution of cash by the children thereby decreasing and increasing, respectively, their outside bases. Because the shift is treated as a constructive distribution of cash to Mr. Developer, the advisor must keep in mind § 731(a)(1) of the Code, which provides that a distribution of cash (constructive or otherwise) from a partnership to a partner that exceeds the partner's outside basis results in gain to that partner. Here, though, the $3 million constructive distribution is far less than Mr. Developer's outside basis.

above). Specifically, a "vertical slice" division of FLLLP would involve a pro rata distribution by the FLLLP of the membership interests in General Dollar Lessor, LLC to Mr. Developer and his children. The marketable securities would remain within the FLLLP while the real estate assets would remain within General Dollar Lessor, LLC. The diagram below illustrates such a division.



(1) Thus, as a result of a "vertical slice" division of FLLLP, Mr. Developer and his children would own 70%/30%, respectively, of two separate partnerships: the FLLLP (which would own $9 million in securities) and General Dollar Lessor, LLC (which would own $31 million in real estate subject to debt of $10 million). As discussed above, this type of "vertical slice" division of FLLLP would not run afoul of the "mixing bowl" or "disguised sale" rules.

(2) Significantly, the partnership division would also avoid the special rule of Section 731(c) of the Code that treats a distribution of marketable securities as a distribution of cash. This is because the division does not involve a distribution of the securities. Otherwise, under Section § 731(c) of the Code, a distribution of marketable securities with a fair market value in excess of a partner's outside basis can trigger gain to the partner.[416]

(3) The effect of a "vertical slice" division on the capital accounts and outside bases of Mr. Developer and his children with respect to FLLLP and General Dollar Lessor, LLC are set forth below:

[416] § 731(a)(1).

	Developer (Includes Family GP, LLC)			Children		
P'ship Division--FLLLP	Capital Accounts	Outside Basis	Fair Market Value	Capital Accounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000
Spin Out Gen'l Dollar Lessor	$0	($10,000,000)	($14,700,000)	$0	$0	($6,300,000)
TOTALS	$4,200,000	$4,200,000	$6,300,000	$1,800,000	$1,800,000	$2,700,000
General Dollar Lessor, LLC	Capital Accounts	Outside Basis	Fair Market Value	Capital Accounts	Outside Basis	Fair Market Value
Initial Balances	$0	$10,000,000	$14,700,000	$0	$0	$6,300,000
Children Indemnify 30% Debt		($3,000,000)			$3,000,000	
TOTALS	$0	$7,000,000	$14,700,000	$0	$3,000,000	$6,300,000

f. With the marketable securities and real estate assets now segregated, upon Mr. Developer's death the discount taken with respect to the estate's partnership interest in FLLLP might be less, thus facilitating a higher step-up in basis in the securities. The estate's partnership interest in General Dollar Lessor, LLC would be subject to a significant discounting, but indemnification of Mr. Developer by the children (as discussed above) could prevent the discount from effectively nullifying the benefit of the basis step-up.

2. Example 2: In-Kind Distributions and Section 754 Election

a. Partner indemnification of debt is not the only means to engage in tax basis management with partnerships. In the right circumstances, the estate-planning advisor should consider in-kind distributions of property from a family partnership to one or more partners.

b. Consider the following hypothetical situation:

(1) Assume that ABC Family LLC owns raw land held for long-term investment. A has a 33.34% interest in ABC Family LLC, while each of A's adult children, B and C, have a 33.33% interest in ABC Family LLC. Each member of ABC Family LLC has an outside basis in his membership interest of $1.5 million.

(2) Assume further that the raw land held by ABC Family LLC is unencumbered and consists of the following three parcels of land: Parcel 1 has an adjusted basis of $4 million but a value of only $2 million; Parcels 2 and 3 each have an adjusted basis of $250,000 and a value of $5 million. Thus, ABC Family LLC is worth a total of $12 million and has an aggregate adjusted basis of $4.5 million in the land. Each member's interest in ABC Family LLC therefore is worth $4 million before taking into account any valuation discounts. Notice as well that the aggregate inside basis of ABC Family LLC in the raw land ($4.5 million) is equal to the aggregate outside basis (3 x $1.5 million = $4.5 million) of the members of ABC Family LLC.[417] Further assume that all capital contributions to ABC Family LLC are outside the seven year prohibition such that the "mixing bowl" and "disguised sale" rules are not implicated.[418]

[417] Typically, absent the death of a partner or a sale or exchange of a partner's partnership interest, the aggregate inside basis of a partnership in its property will equal the aggregate outside basis of the partners in their partnership interests.

[418] If ABC Family LLC has been in existence for at least seven years, and no appreciated or depreciated property has been contributed to the ABC Family LLC by the partners within the past seven years, then the ABC Family LLC will avoid the "mixing bowl" and "disguised sale" rules of IRC §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b).

c. Section 754 Election and Tax Basis Management

(1) Assume that A dies leaving his entire 33.34% membership interest in ABC Family LLC to his children, B and C. Assume that A's membership interest has an outside basis of $1.5 million and a value of $4 million at the time of A's death.[419] ABC Family LLC typically would make a Section 754 election to optimize the estate's step-up in basis in A's membership interest. Pursuant to Section 743(b) of the Code, the election allows A's estate (which ultimately benefits B and C) to adjust its proportionate share of ABC Family LLC's inside basis in the land by a net amount of $2.5 million (i.e., an amount equal to the outside basis step-up in A's membership interest from $1.5 million to $4 million).[420]

(2) It is important to understand that the adjustment under Section 743(b) of the Code is personal to the transferee partner (A's estate, and ultimately B and C). The adjustment is thus made to the transferee's (the estate's) *share of the inside basis* of the partnership in its property, not the partnership's basis in the property itself.[421] In the case of ABC Family LLC, the estate's share (as well as B's and C's respective shares) of the inside basis of the partnership in the land is as follows: Parcel 1 equals $1.334 million (one-third of inside basis of $4 million) and Parcels 2 and 3 equal $83,334 (one-third of inside basis of $250,000 in each parcel).

(3) Next, under Section 755 of the Code, the amount of the adjustment under Section 743(b) of the Code ($2.5 million) must be allocated among the individual items of ABC Family LLC's property. The adjustment to the basis of items of partnership property is determined by reference to what would be the allocation of gains and losses to the transferee partner (A's estate) from a hypothetical sale of the partnership's property.[422] Moreover, the allocation of the adjustment across items of partnership property is made by reference to the net amount of the adjustment. Therefore, some items of partnership property (such as built-in loss property) may be subject to a negative adjustment while other items of partnership property (such as built-in gain property) are subject to a positive adjustment.[423]

(4) If, on a hypothetical sale, after A's death ABC Family LLC sold all of its property for its then fair market value, the gain and loss from such a sale would be allocated to A's estate as follows: $1.583 million gain [one-third of the built-in gain of $4.75 million ($5 million less adjusted basis of $.25 million)] from each of Parcels 2 and 3; and $.667 million loss (one-third of the $2 million built-in loss) from Parcel 1. Accordingly, the $2.5 million net adjustment under Section 743(b) of the Code for the estate with respect to ABC Family LLC is allocated as follows:

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[419] For the sake of simplicity, this example assumes no discounted value on the 33.34% membership interest held by A's estate. Even if A's membership interest is subject to a valuation discount, however, the same principles illustrated here apply.

[420] *See* Treas. Reg. § 1.743-1(b).

[421] *See* § 743(b) (flush language).

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

[423] Treas. Reg. § 1.755-1(b)(1).

(a) decrease the estate's share of inside basis in Parcel 1 to $.667 million (i.e., the estate's pre-adjustment share of inside basis of $1.334 million attributable to Parcel 1 less the estate's $.667 million allocable share of loss on a hypothetical sale); and

(b) increase the estate's share of inside basis in Parcels 2 and 3 to $1.667 million each (i.e., the estate's pre-adjustment share of inside basis of $83,334 per parcel plus the estate's $1.583 million per parcel allocable share of gain from a hypothetical sale).

(5) The ultimate goal of these complicated adjustments is to ensure that if ABC Family LLC sold all of its assets for their fair market values at the time of A's death, the estate would benefit from the step-up in basis and (on a net basis) would not be allocated gain or loss from the sale. And, if we re-examine the facts of our hypothetical, we see that by virtue of the adjustments under Section 743(b) of the Code this result is, in fact, produced. In particular, the estate's inside share of basis with respect to Parcels 1 and 2 has been adjusted to $1.667 million each. Thus, if Parcels 1 and 2 sell for their respective fair market values of $5 million each, the estate's one-third share of the proceeds from each parcel would be $1.667 million (one-third of $5 million), exactly equal to the estate's adjusted share of inside basis per parcel. Thus, no gain or loss with respect to the sale of either Parcel 1 or 2 will be recognized by the estate. Likewise, if Parcel 1 sold for its fair market value of $2 million, the estate's share of the proceeds would be $.667 million (one-third of $2 million), exactly equal to the estate's adjusted share of inside basis with respect to Parcel 1. Again, no gain or loss will be recognized by the estate with respect to the sale of Parcel 1.

d. Benefits to B and C as A's Heirs

(1) If we now examine ABC Family LLC from the perspective of B and C, the heirs to A's estate, we see that on balance the step-up in basis, the Section 754 election, and the corresponding adjustments under Section 743(b) benefit B and C. B and C benefit because $2.5 million of built-in gain within ABC Family LLC that would have been allocable to A prior to his death is now offset by the <u>net</u> $2.5 million adjustments made to Parcels 1, 2, and 3.[424]

(2) Upon closer examination, however, we also see that the result of the $2.5 million net adjustment is not entirely beneficial to B and C. First, there is no question that B and C benefit from the positive adjustment attributable to the estate's share of inside basis

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[424] More specifically, B's and C's shares of inside basis in ABC Family LLC's property were $1.334 million each in Parcel 1 and $83,334 each in Parcels 2 and 3 prior to A's death. Without the Section 754 election and the corresponding adjustments under Section 743(b) of the Code, B's and C's shares of inside basis simply would have reflected their inherited portions of A's inside basis prior to his death: B's and C's share of inside basis in Parcel 1 would have been $2 million each [$1.334 million plus $.666 million, which is one-half of A's former share ($1.334 million) of inside basis in Parcel 1]; and B's and C's respective shares of inside basis in Parcels 2 and 3 would have been $.125 million each [$83,334 plus $41,666, one-half of A's former share ($83,334) of inside basis in each of Parcels 2 and 3].

By virtue of Sections 754 and 743(b) of the Code, however, B's and C's shares of inside basis in Parcels 1, 2, and 3 are as follows: B's and C's respective shares of inside basis in Parcel 1 are lower--$1.667 million each [$1.334 million plus $.3335 million, one-half of the estate's adjusted share ($.667 million) of inside basis in Parcel 1]; B's and C's respective shares of inside basis in Parcels 2 and 3 are higher--$.9175 million each [$83,334 plus $.834 million, one-half of the estate's adjusted share ($1.667 million) of inside basis in each of Parcels 2 and 3].

in Parcels 2 and 3. The adjustment reduces the taxable gain that B and C will report from a sale of either Parcel 2 or 3 by ABC Family LLC. On the other hand, though, the negative adjustment to the estate's share of inside basis in Parcel 1 is unfavorable. This negative adjustment reduces the amount of loss that B and C would report from a sale of Parcel 1 by ABC Family LLC had the Section 754 election not been made.

(3) Put differently, the Section 754 election and corresponding adjustments apply across every item of partnership property. There is no ability to pick and choose which assets to adjust so that built-in gain is reduced while built-in loss is preserved. Nonetheless, ABC Family LLC perhaps could have distributed the built-in loss property, Parcel 1, to A in partial redemption of A's 33.34% membership interest in order to better optimize the favorable aspects of the Section 754 election.

e. Distributing Loss Property to Optimize Section 754 Election

(1) Under Section 731 of the Code, a current (i.e., non-liquidating) in-kind distribution of property (other than money) to a partner generally does not result in the recognition of gain or loss to the partnership or to the distributee partner.[425] Instead, the distributee partner takes a basis in the property equal to but not in excess of the distributing partnership's basis, and the distributee partner reduces his outside basis in his partnership interest by an amount equal to his basis in the distributed property.[426] Moreover, if the distributing partnership makes (or has in effect) a Section 754 election and the distributed property had a basis in the partnership's hands higher than the distributee partner's outside basis in his partnership interest, then the excess results in a positive adjustment under Section 734(b) of the Code to the distributing partnership's basis in its remaining assets.[427] Unlike the adjustments under Section 743(b) of the Code (e.g., arising upon the death of partner), the adjustment under 734(b) of the Code is not personal to the distributee partner. Instead, where it applies, Section 734(b) of the Code creates an upward or downward adjustment in the partnership's basis in its remaining property. Then, under Section 755 of the Code, the adjustment under Section 734(b) of the Code is allocated across the partnership's remaining property according to unrealized appreciation or depreciation among classes and items of property (in accordance with the methodology set forth in the Treasury Regulations).[428]

(2) If we apply these rules in the context of ABC Family LLC, and assume that Parcel 1 (the built-in loss property) is distributed to A prior to his death, then we can produce a more favorable result to B and C (A's heirs) than is produced if Parcel 1 is not distributed and ABC Family LLC makes a Section 754 election upon A's death.

(3) To wit, recall that ABC Family LLC is worth $12 million and that A, B, and C own membership interests in ABC Family LLC worth $4 million each (assuming no valuation discount).[429] A, B, and C have an outside basis of $1.5 million each in their membership interests. Parcel 1 is a built-in loss property with a basis of $4 million and a

[425] § 731(a)-(b). Under Section 731(c) of the Code, though, an in-kind distribution of marketable securities can be treated as a distribution of money triggering gain (but not loss) to the distributee partner.

[426] §§ 732(a) and 733.

[427] *See* § 734(b).

[428] *See* Treas. Reg. § 1.755-1(c).

[429] Again, for the sake of simplicity, this example assumes no discounted value.

value of $2 million. Parcels 2 and 3 are each built-in gain properties with adjusted bases of $20,000 each and values of $5 million each.

(4) Assume that ABC Family LLC distributes Parcel 1 to A prior to his death in partial redemption of his membership interest and also makes a Section 754 election. Under the rules of subchapter K, the following results obtain:

(a) Under Sections 731 and 732 of the Code, A takes Parcel 1 with a value of $2 million and a basis of $1.5 million (exactly equal to A's outside basis in his partnership interest).

(b) Under Section 733 of the Code, A's outside basis in his interest in ABC Family LLC is reduced to zero.

(c) A's percentage interest in ABC Family LLC is reduced to 20% (because A is left with a membership interest worth $2 million in a partnership worth $10 million).[430]

(d) B's and C's percentage interests in ABC Family LLC increase to 40% each (because they each have membership interests worth $4 million in a partnership worth $10 million).

(e) *Most importantly*, an adjustment under Section 734(b) of the Code in the amount of $2.5 million arises from the distribution of Parcel 1 to A (e.g., $4 million inside basis in Parcel 1 less A's $1.5 million outside basis in his membership interest immediately prior to the distribution).

(5) Then, under Section 755 of the Code, the $2.5 million adjustment under Section 734(b) of the Code must be allocated across Parcels 2 and 3 in proportion to the unrealized gain in each parcel. The unrealized gain in each of Parcels 2 and 3 is the same: $4.75 million. ABC Family LLC therefore increases its inside basis in Parcels 2 and 3 by $1.25 million each. This leaves ABC Family LLC holding Parcels 2 and 3 worth $5 million each with an inside adjusted basis of $1.5 million each ($.25 million plus $1.25 million).

(6) Next, assume that A dies holding his 20% membership interest in ABC Family LLC and Parcel 1. A's membership interest had a non-discounted value of $2 million and a basis of zero. Parcel 1 had a value of $2 million and a basis of $1.5 million. A's estate steps up its basis in the ABC Family LLC membership interest from zero to $2 million. A's estate steps up its basis in Parcel 1 from $1.5 million to $2 million. Furthermore, under Section 754 of the Code, the $2 million step-up in the estate's outside basis in its membership interest in ABC Family LLC gives rise to a $2 million adjustment under Section 743(b) of the Code. That $2 million positive adjustment increases the estate's (and ultimately B's and C's) share of inside basis in Parcels 2 and 3 by $1 million each. This $1 million positive adjustment under Section 743(b) of the Code is in addition to the $1.25 million positive adjustment under Section 734(b) of the Code that previously had been made to Parcels 2 and 3 as result of the distribution of Parcel 1 to A.

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[430] As discussed above, non-pro-rata distributions of property in family partnerships almost always should result in adjustment of the partners percentage interests in the partnership. Otherwise, the special valuation rules of Chapter 14 will come into play.

(7) B and C thus inherit from A Parcel 1 with a value of $2 million and a basis of $2 million. There is no longer a trapped, built-in loss in Parcel 1. B and C also inherit from A his 20% interest in ABC Family LLC, leaving B and C owning 50% each of ABC Family LLC. Due to the combination of the adjustments under Sections 734(b) and 743(b) of the Code though, Parcels 2 and 3 effectively have an adjusted basis to B and C of $2.5 million each determined as follows:

(a) Parcels 2 and 3 each had $1.5 million basis after the IRC § 734(b) inside basis adjustments (described above) upon the distribution of Parcel 1 to A.

(b) A's death gives rise to a $2 million adjustment under Section 734(b) of the Code to the estate's share of inside basis in Parcels 2 and 3 which remain held by ABC Family LLC.

(c) Under Section 755 of the Code, this $2 million positive adjustment must be allocated across Parcels 2 and 3 to increase the estate's share of inside basis attributable to Parcels 2 and 3.

(d) The Treasury Regulations under Section 755 of the Code allocate the $2 million adjustment in proportion to relative fair market values of assets inside ABC Family LLC.

(e) Because Parcels 2 and 3 have the same value ($5 million each), the estate's $2 million adjustment under Section 743(b) of the Code is allocated equally between Parcels 2 and 3.

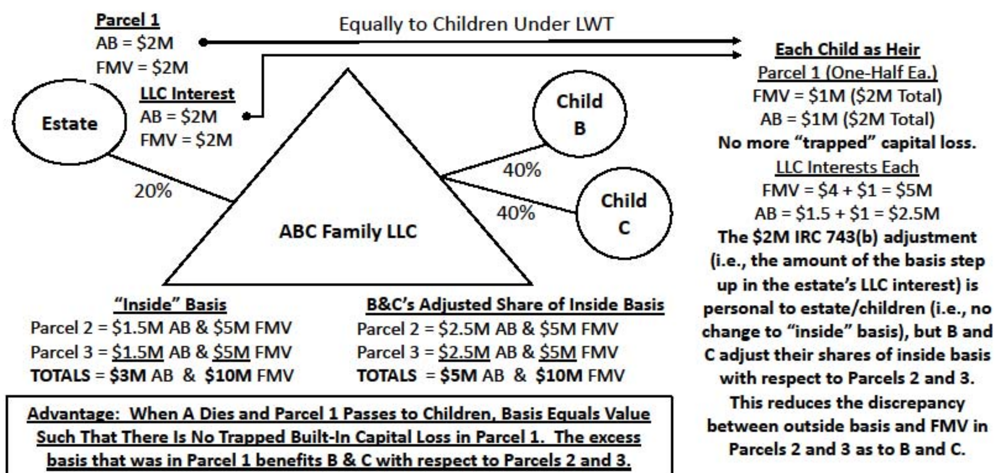
(f) Therefore, the estate's share of the inside basis of ABC Family LLC in Parcels 2 and 3 is $1 million each.

(g) B and C then inherit the estate's share of ABC Family LLC's $1 million inside basis in Parcels 2 and 3.

(h) When combined with ABC Family LLC's existing inside basis of $1.5 million each in Parcels 2 and 3, B's and C's inside shares of basis in Parcels 2 and 3 are now $2.5 million each.

(8) A diagram illustrating the ultimate results to A's estate and to B and C is set forth below:

ABC Family LLC Alternative Two: Step-Up at Death in Parcel 1 and LLC Interest



(9) As can be seen from the foregoing analysis and the diagram, the carefully planned distribution of Parcel 1 optimizes the results of the Section 754 election. In other words, the basis and value of Parcel 1 in B's and C's hands is equal, avoiding receipt of property with built-in loss that can be realized only upon sale. Further, B's and C's inside shares of basis in Parcels 2 and 3 within ABC Family LLC are higher ($2.5 million each versus $1.835 each) than where Parcel 1 is not distributed and A dies holding a 33.34% interest in ABC Family LLC.

(10) In short, the carefully planned distribution of Parcel 1 re-allocated $2 million of excess basis to Parcels 2 and 3 to reduce their built-in gain, rather than trapping a large portion of that excess basis as built-in loss in Parcel 1.

VI. INCOME TAX AVOIDANCE AND DEFERRAL

A. Generally

1. With the higher income tax rates, progressivity in the marginal income tax brackets provides an opportunity for taxpayers to take advantage of "running the brackets" and taxing income at lower effective tax rates. With the highest income tax rates becoming effective at $457,600 of taxable income for joint filers and the 3.8% Medicare tax being applied when MAGI exceeds $250,000, the tax savings can be quite significant. At ordinary rates, "running the bracket" provides approximately $42,954 of tax savings (the difference between being taxed at the highest rate of 43.4% and the actual tax liability) for single filers and $53,247 for joint filers, and at long-term capital gain tax rates, the tax savings are $29,783 and $36,070, respectively:[431]

[431] Rev. Proc. 2013-35, 2013-47 I.R.B. 537, Section 3.01.

STCG/Ordinary Rate	Single ($42,954 in savings)	Joint ($53,247 in savings)
10%	$0-$9,075	$0-$18,150
15%	$9,076-$36,900	$18,151-$73,800
25%	$36,901-$89,350	$73,801-$148,850
28% / 31.8%	$89,351-$186,350	$148,851-$226,850
33% / 36.8%	$186,351-$405,100	$223,851-$405,100
35% / 38.8%	$405,101-$406,750	$405,101-$457,600
39.6% / 43.4%	$406,751+	$457,601+

LTCG/QD Rate	Single ($29,783 in savings)	Joint ($36,070 in savings)
0%	$0-36,900	$0-$73,800
15%	$36,901-*$200,000 MAGI*	$73,801-*$250,000 MAGI*
18.8%	*$200,001 MAGI*-$406,750	*$250,001 MAGI*-$457,600
23.8%	$406,751+	$457,601+

2. As a result, taxpayers will increasingly look for opportunities to not only defer the payment of income taxes (which provides a present value economic benefit) but to have the income spread out over many taxable years and over multiples of taxpayers. This will provide the benefit of having the income taxed at a lower tax rate by running the brackets, and to also fully avoid the imposition of certain taxes like the 3.8% Medicare tax (for such annual amounts that remain below $200,000 to $250,000 of MAGI).

B. "Splitting" Income with Partnerships

1. The most flexible vehicle available to practitioners to "split" income among taxpayers are entities taxed as partnerships. While an S corporation will spread the entity's income across the shareholders, the capital structure of an S corporation investment is limited to one class of stock so there is no ability to disproportionately allocate income to certain shareholders (who are taxed at lower marginal income tax brackets and who may not be subject to state income tax) to the exclusion of other shareholders (who are already at the highest income tax brackets and who may be residents of a high income tax state like California).[432]

2. Unlike S corporations, partnerships can be structured to provide different classes of ownership interests. In the family-owned entity context, if different ownership interests are utilized, careful consideration must be given to Section 2701 of the Code because the

[432] § 1361(b)(1)(D).

"same class"[433] exception will not be available. Notwithstanding the foregoing, "preferred" partnership interests can be created that avoid the punitive effects of Section 2701 of the Code, namely the "zero valuation" rule.[434] These types of "preferred" interests include:

a. A "qualified payment"[435] interest (discussed in more detail later in the following article of this outline), which is an exception to the zero valuation rule;

b. A "deemed" or "electing" qualified payment, which is an exception to zero valuation rule;[436]

c. A "guaranteed payment" right under Section 707(c) of the Code, which is an exception to Section 2701 of the Code;[437] and

d. A "mandatory payment right," which is an exception to Section 2701 of the Code.[438]

3. Generally, the Code and the IRS take the position that if a partner holds a preferred interest in a partnership, taxable income should follow with the preferred interest payment.

a. For guaranteed payment rights, the taxation to the partnership and the partners is relatively straightforward. A partnership that makes a guaranteed payment to partner is entitled to either deduct the payment as an ordinary and necessary business expense[439] of the partnership or capitalize[440] the expense as a capital expenditure, depending on the nature of the payment.[441] The partner receiving the guaranteed payment must include the payment as ordinary

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[433] § 2701(a)(2)(B).

[434] § 2701(a)(3)(A).

[435] § 2701(c)(3)(A).

[436] These are specified amounts to be paid at specified times that nonetheless do not qualify as a "qualified payment" but which the taxpayer elects to treat as such. § 2701(c)(3)(C)(ii).

[437] Excluded from the definition of "distribution right" is "any right to receive any guaranteed payment described in section 707(c) of a fixed amount." § 2701(c)(1)(B)(iii). The Code defines guaranteed payments as "payments to a partner . . . for the use of capital" but only "to the extent determined without regard to the income of the partnership to a partner for . . . the use of capital." § 707(c). The Treasury Regulations go on to explain that a guaranteed payment is meant to provide the partner with a return on the partner's investment of capital (as opposed to payments designed to liquidate the partner's interest in the partnership). Treas. Reg. § 1.707-4(a)(1)(i).

[438] A "mandatory payment right" is a right to a required payment at a specified time. For purposes of Section 2701 of the Code it is considered neither an extraordinary payment right nor a distribution right. It includes a right in preferred stock requiring that the stock be redeemed at its par value on a date certain and it also includes a right to receive specific amount on the death of the holder. Treas. Reg. § 25.2701-2(b)(4)(i). The Service has also ruled that a mandatory payment right includes the right to redeem preferred stock at a stated value plus any accrued and unpaid dividends on the earlier to occur of a certain date or change in control of the company. PLR 9848006.

[439] § 162(a).

[440] § 263.

[441] § 707(c).

income[442] in the year in which the partnership paid or accrued the payment under its method of accounting.[443]

b. For the other types of preferred interests, the allocation of income is a bit more convoluted. Generally, the income allocated to the preferred payment depends on the distributive share of the partnership. The McKee, Nelson and Whitmire treatise provides that the Service expects a preferred return to be matched by a corresponding allocation of available income or gain.[444] The Treasury Regulations, in the context of the disguised sale rules, provide that a preferred return means "a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of gain."[445]

4. With the goal of disproportionately allocating income to lower taxed individuals, practitioners should make note of the "junior equity" exception to Section 2701 of the Code.

a. The Code provides that a distribution right does not include a right to distributions with respect to any interest which is junior to the rights of the transferred interest.[446]

b. The Treasury Regulations also exempt an interest that is of the same class, or a class that is subordinate to, the transferred interest.[447]

c. This is one of the most significant exceptions to Section 2701 of the Code from a tax planning standpoint. Essentially, it is an exception for the transfer of the preferred or senior equity interest (with the retention of the junior equity or common interest by the transferor). As an exception to Section 2701 of the Code, normal gift tax rules apply to such transfer of the preferred interest, along with any applicable valuation discounts for lack of marketability and minority interest discount. Equally as important, as mentioned above, the preferred return will carry a preferred allocation of the tax items of the partnership.

C. Non-Grantor Trusts: Distributions and Partnerships

1. As mentioned above, non-grantor trusts are taxed at the highest rates once taxable income exceeds $12,150 of taxable income. As such, non-grantor trusts carry an inherent income tax disadvantage when compared to how those same assets would grow if they were held by an individual or group of individual taxpayers. Trustee should consider whether making distributions to trust income might better serve the overall purposes of the grantor and the grantor's family, in terms of total wealth accumulation.

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[442] *See* 61(a).

[443] § 706(a) and Treas. Reg. §§ 1.706-1(a)(1) and 1.707-1(c).

[444] McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 13.02[3][b][iii], at 3-19 (3d ed. 1997).

[445] Treas. Reg. § 1.707-4(a)(2).

[446] § 2701(c)(1)(B)(i).

[447] Treas. Reg. § 25.2701-2(b)(3)(i).

2. Even with trusts where the primary objective is to accumulate as much wealth in the trust as possible (for example, a "dynasty trust" or GST tax exempt trust), trustees may be able to produce more total wealth by distributing trust income out to the trust beneficiaries, especially if the trust beneficiaries would be taxed at lower income tax rates, would not be subject to state income tax, and have sufficient Applicable Exemption Amount and GST exemption available to shelter whatever assets may accumulate in the gross estates of the beneficiaries. Given the potential number of taxpayers or beneficiaries a trust could spread the income across, the savings could be significant.

3. Trust distributions that carry out distributable net income ("DNI")[448] of the trust would effectively ensure taxation of the income to the beneficiaries. DNI determines the amount of income that may be deducted by the trust resulting from distributions and determines the character of the income items taxable to the beneficiaries.[449] Determining DNI for a trust requires first determining the taxable income of the trust and modifying that figure in a number of ways. With respect to capital gain, the Code provides, "[g]ains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not . . . paid, credited or required to be distributed to any beneficiary during the taxable year."[450] In other words, absent certain circumstances, capital gain is excluded from DNI and is taxable to the trust, rather than to the beneficiary receiving the distributions.

4. Often the governing instrument will give the trustee the authority to allocate gains between income and principal. Under the Treasury Regulations, however, "Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized."[451] The Treasury Regulations provide that capital gain is ordinarily excluded from DNI, with a number of notable exceptions:[452]

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law)—
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of the distributable net income determined without regard to this subparagraph 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

[448] § 643.

[449] §§ 651(b), 652(a), 652(b), 661(a), 662(a) and 662(b).

[450] I.R.C. § 643(a)(3). *See* Treas. Reg. § 1.643(a)-3(a) regarding the treatment of capital gains and losses in the taxable year in which the trust or estate terminates.

[451] Treas. Reg. § 1.643(b)-1.

[452]Treas. Reg. § 1.643(a)-3(a).

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.[453]

5. Notwithstanding the limited discretion granted to fiduciaries under the foregoing provisions, given the potential limitations of including capital gain in DNI and the fact that many clients would prefer not to have the asset held personally by the beneficiaries, practitioners may be able to accomplish the same types of tax savings by utilizing a partnership structure where the beneficiary is a partner along with the trust. By way of example, the trust could from an entity taxable as a partnership like a limited partnership or limited liability company and distribute an interest in the entity to the beneficiary. Whether such distribution carries out DNI to the beneficiary is secondary to the fact that on an ongoing basis a proportionate amount of partnership income will be allocated to the beneficiary. While a preferred interest partnership structure can be utilized, as discussed above, and practitioners should be aware of the implications under Section 2701 of the Code upon the creation of the preferred partnership with the beneficiary or the distribution of a preferred interest in the partnership to the beneficiary.

6. Given that any partnership interest held by a trust beneficiary will be in his or her gross estate for estate tax purposes, practitioners will want to consider utilizing IDGTs to minimize the estate tax impact but still retain the income tax benefits of having the partnership income taxed to the beneficiary-grantor. For example, the beneficiary may want to sell his or her partnership interest to an IDGT created by the beneficiary, as the grantor for grantor trust purposes.

D. Charitable Remainder Trusts

1. The tax benefits of charitable remainder trusts have dramatically increased with the progressivity of the new income tax rates, especially if a taxpayer is considering a relatively large taxable sale of a highly appreciated investment asset like publicly-traded corporate stock. For example, if a taxpayer sells $5 million of zero basis stock, the effective Federal tax rate of that sale is 22.9% (assuming a long-term holding period), and if a taxpayer sells $10 million of stock, the effective Federal tax rate is 23.4%. In other words, large sales like this in a single taxable year effectively result in virtually all of the gain being taxed at the highest tax bracket (23.8%) because the income thresholds at the highest tax bracket ($406,750/$457,600 and $200,000/$250,000 for the Medicare tax) are so small in comparison to the total taxable income.

2. Contrast how the sale of such stock would be taxed if the stock is first contributed to a charitable remainder trust (most likely, a charitable remainder unitrust given how low the Section 7520 rate is today[454]). A charitable remainder trust is not subject to income

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[453]Treas. Reg. § 1.643(a)-3(b). Since the issuance of the final regulations, the service has ruled that the exclusion and inclusion of capital gains in determining DNI was a reasonable exercise of discretion. *See* PLRs 200617004 and 200448001.

[454] This is due to the interplay of the 5% minimum amount for annuity amounts (Treas. Reg. § 1.664-2(a)(2)(i)), the 5% exhaustion test (Treas. Reg. § 25.2522(c)-3(b)(1)), and the 10% minimum charitable remainder interest requirement (§ 664(d)(1)(D)).

tax,[455] so the trustee's subsequent sale of the appreciated stock will not result in an immediate tax liability to the trust or to the unitrust recipient.

3. The "tier rules" under Section 664(b) and the Treasury Regulations[456] determine the taxability of the unitrust payment to the recipient. The tier rules create a historical accounting of how the charitable remainder trust has realized (but not recognized) income in the administration and investment of the trust assets. Effectively, the tier rules tax each distribution on a "worst-in, first-out" basis with distributions deemed to consist first of ordinary income, then from capital gain, followed by "other" income like tax-exempt bond income, and finally from trust corpus. The final Treasury Regulations make clear that if there are different classes of income in a category, that class of income that would be subject to the highest Federal income tax rate will be deemed to be distributed before a class of income that would be taxed at a lower rate.[457] Hence, ordinary income from taxable bonds will be deemed distributed before qualified dividends, and short-term capital gains will be deemed distributed before long-term capital gains.

4. Notwithstanding the "worst-in, first-out" nature of the annual distributions, if trustees are careful in the investment of the assets, much of each distribution will be taxed at qualified dividend and long-term capital gain rates. Given the large amount of capital gain that is recorded under the "tier rules" when a highly-appreciated asset is initially sold, as annual payments are made to the recipient, the original capital gain is essentially being paid out over time. This effectively results in not only a deferral of the original capital gain tax liability, but to the extent that each annual payment is below the highest income tax threshold, it causes the gain to be taxed at a lower effective rate. For example, assuming the unitrust recipient had no other sources of income, the first $200,000 or $250,000 (depending on whether the recipient filed jointly or as a single filer) would fully avoid the 3.8% Medicare tax and the first $406,750 or $457,600 would be taxed at a rate lower than the highest marginal income tax bracket.

5. The income tax savings become even more compelling if the fully taxable sale would have occurred when the taxpayer was a resident of a high income tax state like California, where the highest bracket of 13.3% is imposed on taxable income over $1 million. A sale of the appreciated stock in a charitable remainder trust would not only provide deferral benefits if the unitrust recipient continued to be a resident of California, but the unitrust recipient could fully avoid the state income tax if the recipient moved to a no state income tax state like Texas, Florida, or Nevada.

E. NINGs/DINGs

1. Taxpayers in high income tax states like California often look for opportunities to defer or avoid their state income tax exposure. In light of this objective, the use of "incomplete gift, non-grantor trusts" has arisen in states that do not have an income tax. Most prevalently, practitioners have taken advantage of the laws of Delaware (Delaware incomplete non-grantor trust or "DING") and Nevada (Nevada incomplete non-grantor trust or "NING").[458]

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[455] § 664(c)(1).

[456] Treas. Reg. § 1.664-1(d).

[457] Treas. Reg. § 1.661-1(D)(1)(ii)*(b)*.

[458] For a more complete discussion of NINGs and DINGs, *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.

Pursuant to this technique, as long as the assets are retained in the DING or NING, the income from such assets will not be subject to state income tax.

2. The salient features of DING and NING planning are:

a. The taxpayer creates a non-grantor trust;

b. The taxpayer contributes assets to the trust that the taxpayer no longer wants to be subject to state income tax;

c. The trust provides that the taxpayer/grantor is a permissible beneficiary of the trust;

d. The contribution of assets to the non-grantor trust are not considered a taxable gift; and

e. The assets in the non-grantor trust will be includible in the taxpayer/grantor's estate for estate tax purposes.

3. Prior to 1997, a self-settled trust (a trust that provides for the benefit of the grantor) like the one described above would not have qualified as a non-grantor trust. The Treasury Regulations provide, "Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor." Thus, if under state law creditors of the grantor can reach the assets of the trust, then the trust will be considered a grantor trust for income tax purposes. Prior to 1997, all of the states provided that creditors of a grantor could reach the assets of any self-settled trust. Since 1997, a number of states like Alaska, Delaware and Nevada have enacted "domestic asset protection trusts" (DAPTs) that purportedly allow grantors to create self-settled trusts but prohibit creditors of the grantor from reaching the assets in the trust.

4. A number of rulings under Delaware law affirmed the non-grantor trust status of the DING.[459] All of the rulings relied upon an incomplete gift predicated upon the grantor retaining a special testamentary power of appointment to redirect the trust assets.[460] Notwithstanding that the grantor was a permissible beneficiary of the trust, the rulings avoided grantor trust status through the use of a distribution committee that had to approve any distribution to the grantor. The members of the distribution committee were deemed to be adverse parties (for example, trust beneficiaries) under Section 672(a) of the Code, and as a result, the trust was not a grantor trust.

5. In 2007, the IRS announced that it was re-examining the question of whether the distribution committee members have a general power of appointment.[461] In 2012, the IRS

Oshins, *NING Trusts Provide Tax and Asset Protection Benefits*, CCH Estate Planning Review - The Journal, Page 150 (Aug. 20, 2013).

[459] PLRs 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005, and 200731019.

[460] *See* Treas. Reg. §§ 25.2511-2(b) and 25.2511-2(c).

[461] IR-2007-127.

ruled that the retention of a testamentary power of appointment makes the original transfer incomplete but only with respect to the remainder interest but not the lead interest.[462]

6. More recent rulings[463] under Nevada law have confirmed the NING technique. The taxpayers in the rulings addressed the power of appointment issue by providing the trust settlor with an inter-vivos special power of appointment for health, education, maintenance and support in a non-fiduciary capacity. Further, the powers of the distribution committee members were only exercisable in conjunction with the grantor. Thus, the IRS ruled that the members did not have general powers of appointment.

VII. CREATIVE USES OF THE APPLICABLE EXCLUSION

A. Qualified "Cost-of-Living" Preferred Interests

1. As mentioned above, there are very good reasons for trying to retain as much Applicable Exclusion Amount as possible, even for very wealthy clients who have significant estate tax exposure. One technique that may be appealing is a traditional preferred freeze partnership, where the grantor retains a preferred interest in the partnership and gifts, or more likely, sells to an IDGT, a common interest in the partnership. The twist would be that the retained preferred interest would be adjusted for inflation to provide inflation-adjusted cash flow and ensure that the retained preferred interest in the gross estate would equal the grantor's Applicable Exclusion Amount on the grantor's death. Pursuant to this technique:

a. The retained preferred interest would be structured as a "qualified payment" interest under Section 2701 of the Code, so the zero valuation rule would not be applicable.

b. The liquidation preference of the preferred interest would be adjusted to provide for a cost-of-living increase, calculated in the same manner as the Applicable Exclusion Amount.

c. The retained preferred interest would be structured so that the preferred holder would have the right to put the interest to the partnership for the liquidation preference (as adjusted for the cost-of-living increase) and at death, the partnership has the right to liquidate the preferred interest at the liquidation preference.

d. The gift or sale of the common interest would qualify for significant valuation discounts, in excess of those that would typically apply to a traditional single class or pro rata family limited partnership.

2. A qualified payment "means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate."[464] A payment will be treated as a "fixed rate" if the payment is "determined at a rate which bears a fixed

[462] CCA 201208026.

[463] PLRs 201310002, 201310003, 201310004, 201310005, and 201310006.

[464] § 2701(c)(3)(A).

relationship to a specified market interest rate."[465] The Treasury Regulations provides that a qualified payment is:

a. "A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate."[466]

b. Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount."[467]

3. A common inflation-sensitive interest rate investment is a Treasury Inflation-Protected Security (TIPS). TIPS, unlike certain U.S. savings bonds, adjust for inflation by providing inflation adjustments to the underlying principal amount and keeping the yield fixed. For example, if a $100,000 TIPS is issued with a 4% yield, then $4,000 of interest will be paid in the first year. Assume inflation is 3% in the ensuing year. The TIPS adjusted principal amount will be $103,000 but the yield remains at 4%. As a result, the ensuing year's interest payment will be $4,120. TIPS are an example of a larger category of investments under the Code, called inflation-indexed debt instrument ("IIDI").[468] An IIDI is defined as a debt instrument that has the following features:[469]

a. It is issued for U.S. dollars and all payments are denominated in the same;

b. Except for a minimum guarantee,[470] each payment is indexed for inflation or deflation; and

c. No payments are subject to any contingencies other than inflation or deflation.[471]

4. Terms of the Qualified "Cost-of-Living" Preferred Interests

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[465] § 2701(c)(3)(B). *See* Treas. Reg. § 25.2701-2(b)(6)(ii).

[466] Treas. Reg. § 25.2701-2(b)(6)(i)(A).

[467] Treas. Reg. § 25.2701-2(b)(6)(i)(B).

[468] *See* Treas. Reg. § 1.1275-7.

[469] Treas. Reg. § 1.1275-7(c)(1).

[470] An additional payment made at maturity if the total inflation-adjusted principal paid on the IIDI is less than the IIDI's stated principal amount. Treas. Reg. § 1.1275-7(c)(5).

[471] A qualified inflation index is any general price or wage index that is updated and published at least monthly by an agency of the U.S. Government. The Treasury Regulations specifically mentioned the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U). Treas. Reg. § 1.1275-7(c)(3).

a. The partnership will provide a cumulative preferential right to partnership cash flow. Typically, this preferential right will be a percentage of a stated liquidation preference amount (for example, 6% of $5.34 million-the current Available Exclusion Amount). In this instance, the liquidation preference would be structured similarly to take into account future inflation or deflation as TIPS would be adjusted.

b. The preferred payment will accrue annually and will be cumulative to the extent payments are not made in any given year. The payment is accrued and payable regardless of partnership profits. As such, while it is normally paid from net cash flow of the partnership, the lack of net cash flow in any given year will not affect the total amount that is due.

c. The preferred payment will go into arrears for up to 4 years after the due date without interest being due on the unpaid preference. After the 4 year period, the unpaid payments will accrue interest at the specified preferred rate (for example, 6%).

d. The partnership agreement will provide that payments may be paid from available cash, first, and, at the discretion of the general partner, with in-kind distributions of partnership property.

e. Upon dissolution, the preferred interest will receive liquidating distributions equal to the liquidation preference amount ($5.34 million as adjusted for inflation) before any distributions are made to non-preferred interest holders.

f. The partnership agreement will provide the partnership the right to call the preferred interest at the liquidation preference amount upon the death of the preferred holder. This effectively freezes the value for transfer tax purposes at the liquidation preference amount and at the taxpayers Applicable Exclusion Amount.

5. Chapter 14 Implications

a. Valuation of the preferred interest in the Subtraction Method under Section 2701 of the Code, because it is a "qualified payment," will be according to regular gift tax rules. It is unclear, however, what standard should be used in valuing the preferred interest. Or, said another way, how does one determine the appropriate preferred annual payment to minimize the gift tax consequences, if any, under Section 2701?

b. As discussed above, to be a "qualified payment" the preferred interest must generally provide for a cumulative and annual payment that is determined at a fixed rate. While certain "bells and whistles" must be ignored, no other requirements are set out in the Code or the Treasury Regulations.

6. Revenue Ruling 83-120

a. Many commentators[472] and the IRS in rulings[473] have asserted that the appropriate standard for valuing the preferred interest is under Revenue Ruling 83-120,[474] pertaining to preferred corporate stock. The Revenue Ruling provides a methodology for valuing preferred interests, based upon 3 primary factors:[475] yield, preferred payment coverage and protection of the liquidation preference.

(1) Yield of the preferred interest is compared against with the dividend yield of "high-grade, publicly traded preferred stock." The required credit rating is not explicitly stated in the ruling. The ruling does point out, however, that "If the rate of interest charged by independent creditors to the [entity] on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred [interest] should be correspondingly higher than the yield on the high quality preferred stock."[476]

(2) The ruling provides that "Coverage of the dividend is measured by the ratio of the sum of the pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends."[477] Obviously, in the partnership context, due to pass-thru taxation under Subchapter K, concerns about pre-tax earnings and after-tax dividends are not relevant. Coverage is further supported if the partnership agreement provides that the preferred payment can be satisfied from both cash flow of the partnership and distributions in-kind of partnership assets.

(3) Protection of the liquidation preference is determined by comparing the value of the partnerships assets (net of liabilities) to the liquidation preference amount. In other words, what is the ratio of preferred interests in comparison to non-preferred interests?

b. From a planning perspective, dividend (preferred payment) coverage and liquidation protection are within the control of the planner (whereas the yield on publicly-traded preferred stocks is determined by the vagaries of the market at the time of the purported transfer). In other words, if a FLP is being recapitalized into a qualified payment preferred FLP, then how much dividend coverage or liquidation protection is a function of the sizing between the preferred and common interests. For example, dividend coverage and liquidation protection would be quite different if AB partnership, which holds $10,000,000 of assets is structured, as follows: (i) A holding a 7% preferred on a $5,000,000 liquidation preference amount and B holding the common shares, and (ii) A holding a 7% preferred on a $9,000,000 liquidation preference amount and B holding the common shares. In the first instance, the effective yield that must be paid from the portfolio is 3.5% per year and there is 2:1 ratio of liquidation protection

[472] *See, e.g.,* Milford B. Hatcher, Jr. and Edward M. Manigault, *Warming Up to the Freeze Partnership*, Estate & Personal Financial Planning (June 2000).

[473] *See, e.g.,* PLR 9324018.

[474] Rev. Rul. 83-120, 1983-2 C.B. 170.

[475] The ruling also indicates that voting rights and lack of marketability are secondary factors, but these may cancel each other out in many instances. Rev. Rul. 83-120, 1983-2 C.B. 170 at Sections 4.01, 4.05 and 4.06.

[476] Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.02.

[477] Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.03.

($10,000,000 of assets to satisfy a $5,000,000 liquidation preference), and in the second instance, the effective yield is 6.3% and there is a 10:9 ratio of liquidation protection ($10,000,000 of assets to satisfy a $5,000,000 liquidation preference). In the latter instance, the value of the preferred interest would most likely be much less than the liquidation preference of $9,000,000 because the required yield from the partnership is considerably higher (less dividend coverage) and there is very little cushion of liquidation protection.

7. The yield on a qualified "cost-of-living" preferred interest will be less than the yield on a liquidation preference that is fixed, just as the yield on TIPS is less than the yield on bonds that are not inflation-adjusted. This difference is referred to as "breakeven inflation." Breakeven inflation is the difference between the nominal yield on a fixed rate investment and the "real yield" on an inflation-adjusted investment of similar maturity and credit quality.

8. Practitioners may want to consider providing for a provision in the partnership or membership agreement that provides upon liquidation of the preferred holder's interest at death (equal to the liquidation preference), it shall be satisfied, to the extent possible, with assets that are most appreciated at the time of death. Whether a Section 754 election is in place or not, these assets should be received without any tax consequences and with a full step-up in basis.[478]

B. "Busted" Section 2701 Preferred Interests

1. A "busted" section 2701 preferred interest involves the creation of a preferred interest in a partnership or limited liability company that is not a "qualified payment" under Section 2701(c)(3) of the Code and gifting the common interest in a manner that mandates the "zero valuation" rule under the "subtraction method." Typically, the preferred interest payment is non-cumulative.

2. For example, taxpayer owns an LLC that holds $5 million in assets. Taxpayer recapitalizes the LLC into preferred and common interests. The preferred interests have a $5 million liquidation preference and an 8% non-cumulative preferred annual payment ($400,000). The preferred holder has the right to put the preferred interest to the LLC at any time for the liquidation preference. The LLC has the right to liquidate the preferred interest for $5 million at the death of the preferred holder. The taxpayer gifts the common interests to an IDGT.

a. The preferred interest is not a "qualified payment" under Section 2701(c)(3) of the Code. As such, the value of the gifted common interest will be determined using the "subtraction method" described in the Treasury Regulations,[479] with the preferred interest (family-held senior equity[480] interest) being assigned a value of zero in step 2 of the subtraction method.

b. The value attributed (with the preferred interest having a zero value) to transferred common interest may be entitled to valuation discounts. The Treasury Regulations provide if the value of the transferred interest would have been determined (but for Section 2701) with a "minority or similar discount," the amount of the gift is reduced by the excess of a "pro

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[478] *See* § 736(b).

[479] Treas. Reg. § 25.2701-3.

[480] Senior equity interest is "an equity interest in the entity that carries a right to distribution of income or capital that is preferred as to the rights of the transferred interest." Treas. Reg. § 25.2701-3(a)(2)(ii).

rata portion of the fair market value[481] of the family-held interests of the same class" over "the value of the transferred interest (without regard to section 2701)."[482] The Service has ruled that "minority or similar discount" includes a "discount for lack of marketability" with respect to the transferred interest (when the preferred interest was valued at zero).[483]

3. If, for the sake of simplicity, we assume in this example, the gift of the common is calculated to be exactly $5 million. Why would a taxpayer consider making this gift? The answer lies in the calculation of the estate tax upon the taxpayer's death. The tentative federal estate tax (before credits) is essentially computed against the sum of the decedent's taxable estate,[484] and the "amount of adjusted taxable gifts."[485] The Treasury Regulations provide that if an individual (referred to as the "initial transferor") makes a transfer subject to Section 2701 of the Code, "in determining the Federal estate tax with respect to an initial transferor, the executor of the initial transferor's estate may reduce the amount on which the decedent's tentative tax is computed under section 2001(b)… by the amount of the reduction."[486]

(1) Assuming there has been no subsequent transfer of the retained preferred interest, the amount of the reduction is the "amount by which the initial transferor's taxable gifts were increased as a result of the application of section 2701 to the initial transfer." [487]

(2) In other words, in our simple example, the amount of the reduction is exactly $5 million (the increase of the gift of the common). However, because the non-cumulative preferred can be liquidated at $5 million, the amount includible is also $5 million. As such, these two amounts should cancel each other out.

(3) The Treasury Regulations provide the following example that makes it clear that the reduction in adjusted taxable gifts is frozen in value:

> P, an individual, holds 1,500 shares of $1,000 par value preferred stock of X corporation (bearing an annual noncumulative dividend of $100 per share that may be put to X at any time for par value) and 1,000 shares of voting common stock of X. There is no other outstanding common stock of X.[488]
>
> P continues to hold the preferred stock until P's death. The chapter 11 value of the preferred stock at the date of P's death is the same as the fair market value of the preferred stock at the time of the initial transfer. In computing the Federal

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[481] The Treasury Regulations provide, the value is "determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701." Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

[482] Treas. Reg. § 25.2701-3(b)(4)(ii).

[483] Tech. Adv. Mem. 9447004.

[484] § 2001(b)(1)(A).

[485] § 2001(b)(1)(B).

[486] Treas. Reg. § 25.2701-5(a)(3).

[487] Treas. Reg. § 25.2701-5(b)(2).

[488] Treas. Reg. § 25.2701-5(d)(1)(i).

estate tax with respect to P's estate, P's executor is entitled to a reduction of $1,500,000 under paragraph (a)(3) of this section.[489]

4. The benefit to the taxpayer is that for as long as the taxpayer holds the preferred interest, the taxpayer presumably can choose to receive the preferred payment or not. If no preferred payment is received, all of the appreciation effectively passes to the common interests. The preferred interest is frozen in value with a reduction for estate tax purposes that essentially "zeroes-out" the estate tax liability attributable to the preferred.

5. Practitioners may want to consider providing for a provision in the partnership or membership agreement that provides upon liquidation of the preferred holder's interest at death (equal to the liquidation preference), it shall be satisfied, to the extent possible, with assets that are most appreciated at the time of death. Whether a Section 754 election is in place or not, these assets should be received without any tax consequences and with a full step-up in basis.[490]

C. Private Annuity Sales

1. Generally

a. A private annuity involves the transfer of property from the transferor in exchange for the transferee's promise to make annual fixed payments for the lifetime of the transferor (or transferors). The transferor may be an individual or a revocable living trust, and the transferee may be an individual or an entity, such as a trust, a partnership, or a corporation. Typically, private annuity sales are to IDGTs (rather than non-grantor trusts)[491] for the benefit of the transferor's descendants. Business interests are often sold to the IDGT at a purchase price that takes into account significant valuation discounts. Alternatively, one can redeem the stock by a closely held corporation in exchange for a private annuity.[492]

b. When interest rates are low as they are today, private annuity sales offer significant estate tax savings because upon the death of the annuitant, when properly structured, the transferred property is not includible in the estate.[493]

c. In private annuity sale, the valuation tables under Section 7520 of the Code must be utilized. The valuation tables assume that the transferor, in a private annuity for life, receives the full payments according to his or her actuarial life expectancy. If the transferor dies before reaching his or her actuarial life expectancy, then the transferor has substantially depleted his or her gross estate.

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[489] Treas. Reg. § 25.2701-5(d)(3), Ex. 2.

[490] *See* § 736(b).

[491] Treasury eliminated the income tax deferral associated with taxable private annuity sales (to non-grantor trusts) by requiring the immediate recognition of gain on any appreciated property exchanged for a private annuity. The amount received for the property equals the current fair market value of the annuity contract, determined under § 7520. Prop. Treas. Reg. §§ 1.72-6(e) and 1.1001-1(j).

[492] *See* PLRs 8316154, 8313073 and 8301036. *See*, *also*, *Fehrs Finance Co. v. Commissioner*, 487 F.2d 184 (8th Cir. 1973), *cert. den.*, 416 U.S. 938.

[493] GCM 39503 (5/7/86), Issue 1.

2. Exhaustion Test

a. The Treasury Regulations provide, in pertinent part, "[a] standard section 7520 annuity factor may not be used to determine the present value of an annuity for… the life of one or more individuals unless the effect of the trust, will, or other governing instrument is to ensure that the annuity will be paid for the entire defined period. In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate at the valuation date of the transfer, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110."[494]

b. This provision applicable to lifetime terms, also known as the "110 year exhaustion test" has the practical effect of forcing grantors to either: (i) limit the annuity term to the shorter of a term of years (determined by when the fund will be exhausted) or the prior death of the measuring life,[495] or (ii) significantly "over funding" the trust with additional assets (above the determined charitable amount pursuant to the 110 year exhaustion test).

c. With the permanent increase of the Applicable Exclusion Amount to $5.25 million per individual and the setting of the top transfer tax rate at 40%, the ability to "over fund" a CLAT at little or no transfer tax cost has dramatically increased, particularly for those individuals who live in states with no gift tax (all states other than Connecticut and Minnesota currently).

d. The Treasury Regulations also provide limitations with respect to the 110 year exhaustion test when there is "unproductive property" in the trust.[496]

3. Avoiding Section 2036

a. Section 2036(a) of the Code provides, "[t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."[497]

b. The Service may attack private annuity sales under Section 2036(a), especially under circumstances when the income corresponds exactly to the payments or the transferor retained a life estate. The key issue is whether the bona fide sale for an adequate and full consideration in money or money's worth exception applies or not.

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[494] Treas. Reg. §§ 1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i), and 25.7520-3(b)(2)(i).

[495] *See* Treas. Reg. § 25.7520-3(b)(2)(v), *Ex. 5*, and Treas. Reg. § 25.7520-3T(b)(2)(v), *Ex. 5*.

[496] *See* Treas. Reg. § 25.7520-3(b)(2)(v), *Ex. 1* and Treas. Reg. § 25.7520-3T(b)(2)(v), *Ex. 1*.

[497] § 2036(a).

c. Two revenue rulings illustrate the risk under Section 2036(a) when the annuity equals the income of the transferred property.

(1) In Revenue Ruling 68-183,[498] the grantor of a trust sold stock in a corporation having a fair market value of $700x in exchange for the trust's contractual obligation to pay him $40x each year for the rest of his life. The current income yield of the property held in the trust was said to equal $40x per year. The only funds available for making the annual payment to the grantor were those payments received as income by the trust. The Service ruled that, although the transaction purported to be a sale of the stock to the trust, in substance the transaction was a contribution of stock to the trust with the reservation of an income interest in the trust for life. Because all the income of the trust was used to make payments to the grantor, he was considered to be the owner of the trust under Section 677(a) of the grantor trust rules, and the trust corpus would be included in his estate under Section 2036.

(2) In Revenue Ruling 79-94,[499] the taxpayer transferred the right to income from an irrevocable trust to the children in return for the children's agreement to make annuity payments that were not less than the trust income or a specified amount that was less than the average trust income. The Service ruled that the trust corpus was includible in his gross estate under Section 2036(a) because of the likelihood that the children would never have to make payments from their own funds and the decedent had received no consideration for the transfer.

d. There have been a numerous cases on the issue of whether the transferor created a private annuity or made a transfer to a trust and retained a life interest. Two cases are instructive:

(1) In *Weigl v. Commissioner*,[500] the Tax Court addressed the issue of whether a taxpayer sufficiently controlled a trust to be treated as the trust's grantor for income tax purposes, as opposed to being the purchaser of a private annuity. The court cited several factors in distinguishing whether the transferor entered into an annuity transaction or a transfer in trust with a retained interest. Based upon these factors and the facts of the case, the court found that the taxpayer effectively controlled the trust in a number of ways and, thus, was the grantor of the trust, rather than having entered into a bona fide annuity transaction. The factors cited by the Tax Court include:

(a) relationship between the creation of the trust and transfer of the property to the trust;

(b) relationship between the income generated by the transfer of property and the amount of the annuity payments;

(c) degree of control over the transferred property exercisable by the transferor;

(d) nature and extent of the transferor's continuing interest in the transferred property;

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[498] Rev. Rul. 68-183, 1968-1 C.B. 308.

[499] Rev. Rul. 79-94, 1979-1 C.B. 296.

[500] 552 84 T.C. 1192 (1985).

(e) source of the annuity payments; and

(f) arm's-length nature of the annuity-sale arrangement.

(2) In *Ray v. United States*,[501] the taxpayer argued that a private annuity resulted despite the fact that the trust agreement on its face purported to be a transfer in trust and not a sale in exchange for an annuity. In addition, the structure of the trust indicated an intent to preserve the principal of the property rather than, on an actuarial basis, exhausting all income and principal as would be done in the case of an annuity. It was also clear that the transaction was structured so that the income of the trust would be the source of the payments to be made. In view of these facts, the court indicated that the entire substance of the transaction reflected an intent to establish a trust rather than a sale in exchange for an annuity.

e. The cases and rulings under Section 2036 indicate that in order to avoid estate tax inclusion the following factors would be helpful:

(1) The annuity agreement should create a liability to the transferee that exists without regard to whether the property transferred produces income.

(2) The annuity payment is in an amount that substantially differs from any income that is produced by the transferred property.

(3) The transferee should have assets in addition to those that were transferred in exchange for the annuity promise since adequate funding indicates a high probability of satisfying the payments.

f. The absence of some of the foregoing factors has allowed the Service to successfully recast a private annuity transaction as a transfer with a retained interest under Section 2036(a) of the Code:

(1) The transferor retained an interest in the transferred property;[502]

(2) The transferee is not personally liable for the annuity payments;[503]

(3) The annuity payments have been secured;[504]

(4) The transferee has no independent financial means from which to make annuity payments;[505]

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[501] 553 762 F.2d 1361 (9th Cir. 1985), aff'g 84-2 USTC ¶ 13,584 (E.D. Wash. 1984).

[502] *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), *Becklenberg Estate v. Commissioner*, 273 F.2d 297 (7th Cir. 1959), *rev'g* 31 T.C. 402 (1958), and *Cain v. Commissioner*, 37 T.C. 185 (1961), *acq*., 1962-2 C.B. 4.

[503] Rev. Rul. 68-183, 1968-1 C.B. 308.

[504] *212 Corp. v. Commissioner*, 70 T.C. 788 (1978) and *Bell Estate v. Commissioner*, 60 T.C. 469 (1973).

[505] *Mitchell Estate v. Commissioner*, T.C. Memo 1982-185.

(5) The annuity payments are identical or substantially similar to the income generated from the transferred assets;[506] and

(6) The chance transferee would ever be called upon to make annuity payments from the transferee's own funds is remote.[507]

g. If Section 2036(a) of the Code applies but the bona fide sale for adequate and full consideration exception exists, then the estate will only include the excess of the fair market value over the value of the consideration. In technical memorandum,[508] the National Office addressed whether private annuities received by a decedent in exchange for the transfer of real property before death constituted adequate consideration in money or money's worth. During the decedent's lifetime, after the decedent had suffered from a number of illnesses and physical ailments, the decedent transferred separate parcels of real property in exchange for a down payment of $10,000 and an annuity for the decedent's life. The decedent immediately forgave the entire down payments. There was no indication that any child made the next annual annuity payment, due one month before the decedent died a year later. The National Office advised that the value of the private annuities received by the decedent did not constitute adequate consideration for federal gift tax purposes.

VIII. CONCLUSION

The new tax environment has catapulted income tax planning and tax basis management front and center in the minds of clients. Thus, they should become front and center in the minds of estate planners as well. As such, this requires an adjustment in the mindset of estate planners who have become accustomed only to looking at the transfer tax consequences of estate planning. Moreover, this will require the modification of traditional estate planning structures to accomplish new objectives in this new paradigm.

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[506] *Ray v. U.S.*, 762 F.2d 1361 (9th Cir. 1985), *Greene v. U.S.*, 237 F.2d 848 (7th Cir. 1956), *Lazarus v. Commissioner*, 58 T.C. 854 (1972), *acq*., 1973-2 C.B. 2, *aff'd*, 513 F.2d 824 (9th Cir. 1975); Rev. Rul. 79-94, 1979-1 C.B. 296.

[507] *Greene v. U.S.*, 237 F.2d 848 (7th Cir. 1956) and Rev. Rul. 79-94, 1979-1 C.B. 296.

[508] TAM 9513001.

APPENDIX A
SUMMARY OF STATE INCOME AND DEATH TAX RATES
(AS OF DECEMBER 31, 2013)

State	State Income Tax[1]	Top State Death Tax Rate[2]	2013 State Death Tax Threshold[2]
Alabama	5.00%	No state death tax	
Alaska	0.00%	No state death tax	
Arizona	4.54%	No state death tax	
Arkansas[3]	4.90%	No state death tax	
California	13.30%	No state death tax	
Colorado	4.63%	No state death tax	
Connecticut (Estate & Gift Tax)	6.70%	12% (Estate & Gift Tax)	$2,000,000 (Estate & Gift Tax)
Delaware	6.75%	16.00%	$5,250,000 (Indexed for Inflation)
District of Columbia	8.95%	16.00%	$1,000,000
Florida	0.00%	No state death tax	
Georgia	6.00%	No state death tax	
Hawaii	11.00%	16.00%	$5,250,000 (indexed for inflation)
Idaho	7.40%	No state death tax	
Illinois	5.00%	15.70%	$4,000,000
Indiana	3.40%	No state death tax	Inheritance tax repealed in 2013
Iowa (Inheritance Tax)	8.98%	Inheritance Tax - No tax on lineal heirs	
Kansas	4.90%	No state death tax	
Kentucky (Inheritance Tax)	6.00%	Inheritance Tax - No tax on lineal heirs	
Louisiana	6.00%	No state death tax	
Maine	7.95%	12.00%	$2,000,000
Maryland (Estate & Inheritance Tax)	5.75%	16.00%	$1,000,000; Inheritance Tax - No tax on lineal heirs
Massachusetts	5.25%	16.00%	$1,000,000
Michigan	4.25%	No state death tax	
Minnesota (Estate & Gift Tax)	9.85%	16% (Estate Tax); 10% (Gift Tax)	$1,000,000 (Estate Tax); $1,000,000 (Gift Tax)

Mississippi	5.00%	No state death tax	
Missouri	6.00%	No state death tax	
Montana[4]	4.90%	No state death tax	
Nebraska (County Inheritance Tax)	6.84%	1.00%	County inheritance tax
Nevada	0.00%	No state death tax	
New Hampshire[8]	0.00%	No state death tax	
New Jersey (Estate & Inheritance Tax)	8.97%	16.00%	$675,000; Inheritance Tax - No tax on lineal heirs
New Mexico[5]	2.45%	No state death tax	
New York	8.82%	16.00%	$1,000,000
New York City	12.70%	16.00%	$1,000,000
North Carolina	7.75%	No state death tax	Estate tax repealed in 2013
North Dakota[3]	2.79%	No state death tax	
Ohio	5.93%	No state death tax	
Oklahoma	5.25%	No state death tax	
Oregon	9.90%	16.00%	$1,000,000
Pennsylvania (Inheritance Tax)	3.07%	4.50%	$3,500 (family exemption amount, may not apply in all circumstances)
Rhode Island	5.99%	16.00%	$910,725
South Carolina[6]	3.92%	No state death tax	
South Dakota	0.00%	No state death tax	
Tennessee[7] (Inheritance Tax)	6.0% (on income from dividends, interest, and capital gain distributions from mutual funds). No income tax on other capital gain.	9.50%	Inheritance Tax - Top rate for lineal heirs is 9.5%-exemption $1.25 million (for 2013 deaths); increases to $2 million for 2014 deaths, $5 million for 2015 deaths, and is eliminated beginning in 2016 Tenn. Code Ann. § 67-8-316 (b) (2011), as amended by Tenn. Pub. Act ch. 1057.

Texas	0.00%	0.00%	No state death tax
Utah	5.00%	0.00%	No state death tax
Vermont[9]	8.95%	16.00%	$2,750,000
Virginia	5.75%	0.00%	No state death tax
Washington	0.00%	20.00%	$2,000,000 (indexed against the consumer price index for the Seattle-Tacoma-Bremerton metropolitan area)
West Virginia	6.50%	0.00%	No state death tax
Wisconsin[3]	5.43%	0.00%	No state death tax
Wyoming	0.00%	0.00%	No state death tax

[1]Source: TaxFoundation.org
[2]Source: Survey of State Estate, Inheritance, and Gift Taxes (Updated: December 2012); Research Department Minnesota House of Representatives (Joel Michael, Legislative Analyst)
[3]Tax payers may exclude 30% of net long-term capital gain for state taxes, tax rate displayed is 70% of the state income tax rate.
[4]Taxpayers can claim a capital gains tax credit against their Montana income tax up to 2% of their net capital gain; tax rate displayed is net of credit.
[5]Taxpayers may deduct $1,000, or 50% of your net capital gains, whichever is greater; tax rate displayed is net of 50% deduction.
[6]Net capital gains which have been held for a period of more than one year and have been included in South Carolina taxable income are reduced by 44% for South Carolina income tax purposes.

[7]6% of state income tax on dividends & interest only.
[8]5% tax on interest and dividends only.
[9] A flat exclusion is allowed for capital gains held longer than 3 years equal to the lesser of $5,000 or 40% Federal taxable income.

APPENDIX B

NOTES ON THE WEALTH FORECASTING SYSTEM

The Bernstein Wealth Forecasting System uses a Monte Carlo model that simulates 10,000 plausible paths of return for each asset class and inflation; it produces a probability distribution of outcomes, based on Bernstein's estimates of the range of returns for the applicable capital markets over the appropriate time period. The model does not draw randomly from a set of historical returns to produce estimates for the future. Instead, the forecasts (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of the analysis; and (4) factor in a reasonable degree of randomness and unpredictability.

Capital Market Projections & Notes on Wealth Forecasting System

	Median 20-Year Growth Rate	Mean Annual Return	Mean Annual Income	One-Year Volatility	20-Year Annual Equivalent Volatility
Municipal Cash	1.9	2.1	2.1	0.2	5.2
Cash Equivalents	2.7	3.0	3.0	0.3	7.1
Short Term Taxables	3.9	4.2	4.5	0.9	7.0
Int-Term Taxables	3.6	3.8	5.1	4.5	6.1
US Diversified	7.9	9.4	2.8	16.3	16.1
US Value	8.2	9.6	3.4	15.8	16.0
US Growth	7.6	9.5	2.3	18.2	17.5
US SMID	8.1	10.1	2.4	18.5	18.6
Developed International	8.7	10.6	3.9	17.9	17.1
Emerging Markets	6.8	10.7	3.7	26.6	26.3
Inflation	3.1	3.3	N.A	1.1	8.0

Notes:

The Bernstein Wealth Forecasting System uses a Monte Carlo model that simulates 10,000 plausible paths of return for each asset class and inflation; it produces a probability distribution of outcomes, based on Bernstein's estimates of the range of returns for the applicable capital markets over the appropriate time period. The model does not draw randomly from a set of historical returns to produce estimates for the future. Instead, the forecasts (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of the analysis; and (4) factor in a reasonable degree of randomness and unpredictability.

"Global Equities" is defined as 21% US Diversified, 21% US Value, 21% US Growth, 7% US SMID, 22.5% Developed International, 7.5% Emerging Markets.

Does not represent any past performance and is not a guarantee of any future specific risk-levels or returns, or any specific range of risk-levels or returns.
Based on 10,000 simulated trials each consisting of 20-year periods.
Reflects Bernstein's estimates, and the capital market conditions of March 31, 2012.

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