Liquidating Family Partnerships: Distribution Planning and Avoiding Income and Gift Tax

By

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LIQUIDATING FAMILY PARTNERSHIPS: DISTRIBUTION PLANNING AND AVOIDING INCOME TAX AND GIFT TAX

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I. INTRODUCTION

Estate planning practitioners frequently encounter a family controlled entity that has outlived its useful life. This may be because the owners no longer have a taxable estate, or because their interests are so divergent from one another that they wish to part ways. Alternatively, it may be a good time for the elderly owner with a taxable estate to redeem his or her interest to avoid including that interest in his or her taxable estate. While the redemption proceeds will be substituted in its place, it may at a fraction of the value of the underlying assets if they are redeemed at a discounted buy-out price rather than the IRS's new higher "hypothetical value" that ignores many of the actual restrictions in the partnership agreement as suggested by the new proposed regulations under Section 2704(b).

However, dissolving a family partnership, or redeeming one of its members, is fraught with income tax traps and now with potentially gift tax traps unless the practitioner carefully plans the transaction and seeks the advice of someone knowledgeable about partnership income tax and the new Section 2704(b) regulations. This outline discusses some of the most common traps in dissolving or redeeming a family partnership and suggests some practical ways to avoid triggering the tax traps. Failure to understand these rules can lead to costly and embarrassing mistakes. Hopefully this outline will supply some needed guidance on these issues.

II. INSIDE AND OUTSIDE BASIS

One of the most important questions in deciding to liquidate a family partnership is what is the basis and market value of the assets owned by the partnership. That usually entails knowing how the partner acquired his or her interest in the partnership. The estate is entitled to adjust the basis of a decedent's partnership interest to the date of death value and the holding period of the partnership interest automatically becomes long-term.[1] However, the basis of partnership assets is not adjusted unless the partnership makes a Section 754 election.[2] Nor do the partnership assets receive a new holding period because of the decedent's death. Therefore, the partnership must hold the assets for more than one year before sale to obtain long-term capital gain treatment, even for assets on hand on the partner's date of death.

A. Inside Basis and Value of Partnership Assets

The executor needs to know the basis and value of the partnership assets on the date of death for several purposes. The basis of the assets on the partnership books is known as the "inside basis." The difference between the inside basis and the market value of the partnership assets helps the general partner decide whether to make a Section 754 election.[3] It also helps him determine whether the partnership is subject to the mandatory basis adjustment rules for substantial built-in losses.[4] And finally it helps him determine whether there is any income in

[1] IRC § 1223(11).

[2] See discussion at III.

[3] See discussion at III.

[4] IRC § 743(b).

respect of a decedent in the partnership. Therefore, the partnership should provide the executor the basis and market value of each partnership asset on the date of death. In addition, the executor should obtain an appraisal of the partnership interest, which considers discounts if the decedent had a minority interest or restrictions on the transfer of his partnership interest.

B. Valuation Discounts

Family partnership interests are often discounted from 15 to 60 percent in the estate inventory due to restrictions on the partnership interests that make them worth less than the underlying assets.[5] As a general rule, the allowable discounts are related to the risks of the underlying investments held by the entity. Discounts are popular because they reduce the size of the taxable estate and allow more value to pass to the beneficiaries. But with fewer estates being taxable because of an increased estate tax exemption, the availability of the unused exemption of the predeceased spouse, and a lifetime of making incremental gifts, the question arises whether discounts should still be claimed when they won't reduce the estate taxes. This is especially true now that the IRS has issued proposed regulations under Section 2704 to curtail the amount of the discounts being taken on gifts of interests in family controlled entities.[6]

The downside of claiming a discount is that the partnership basis is reduced (whether outside or inside), which may ultimately cause more income tax to be paid on sale of the partnership assets. An estate can save estate taxes equal to 40 percent of the discount. However, the discount also reduces the basis of the partnership interest, and the inside basis of the partnership assets if a 754 election is made. Therefore, the discount will *cost* the estate additional income taxes when the assets are sold equal to 20 percent of the discount. If the estate is taxable, it comes out ahead with the discount, despite the additional income tax on sale of the assets. However, if the estate is not taxable, discounts can cost the estate money by reducing the basis of the assets with no offsetting estate tax savings. Thus the question arises whether the executor can simply choose to ignore the discounts.

Case law generally holds that discounts on family investment partnerships are warranted when there are bona fide non-tax reasons for forming the partnership, there are enforceable restrictions on transferring the partnership interest, and the partner has no control over the partnership.[7] Even where the partnership's assets consist mostly of cash, the IRS and Tax Court have upheld a 7 1/2 percent discount simply because the partnership interest is not worth as much as the underlying assets.[8] In *Koons v. Commissioner*, the Tax Court held that where a partner had control over the partnership and could force a distribution or liquidation, the value of his interest should be no less than liquidation value.[9]

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[5] Strangi v. Comm'r, 115 TC 478, *affd on this issue sub nom* Gulig v. Comm'r, 293 F3d 279 (5th Cir 2002); McCord v. Comm'r , 120 TC 358; Lappo v. Comm'r TC Memo 2003-258, Peracchio v. Comm'r, TC Memo 2003-280; Kelley v. Comm'r, TC Memo 2005-235; Temple v. United States, 423 F Supp 2d 605 (DC TX 2006); Astleford v. Comm'r, TC Memo 2008-128, Holman v. Comm'r., 130 TC 170; Pierre v. Comm'r, TC Memo 2010-106; Keller v. Comm'r, 697 F.3d 238 (5th Cir. 2012); Murphy v. United States, 104 AFTR 2d 2009-7703 (DC AR); Gallagher v. Comm'r, 101 T.C. Memo 1702 (2011); Purdue v. Comm'r., TC Memo 2015-249.

[6] See discussion at Section V. *infra.*

7 Supra note 5.

[8] Koons v. Comm'r, TC Memo 2013-94.

[9] *Id.*

However, the IRS and the courts have disallowed discounts entirely when there was no bona fide non-tax reason to form the partnership and the donor or decedent exercised control over the partnership assets.[10] They do this by invoking IRC § 2036(a), which includes the partnership assets in the decedent's estate rather than the partnership interest. But absent a § 2036 challenge, there is little justification to ignore discounts altogether, regardless of whether they are needed to reduce the estate taxes. Moreover, it would be hard to claim no discount if the donor or decedent claimed discounts on prior gift tax returns or on the estate of a predeceased spouse. Consequently, some discount should be claimed on family partnerships, regardless of whether a Form 706 is required. But they may be less aggressive, say 15 to 20 percent.

If discounts are not needed and will increase the income tax on sale of the assets, the family should consider dissolving the partnership. If the decedent has already died, the executor might be justified in claiming no discount on the basis that IRC § 2036 would apply because the decedent had no non-tax motive for forming the partnership and exercised control over the partnership assets. Section 2036 is not just a tool for the IRS. It may be asserted by the taxpayer.

C. Pre-Contribution Gains and Losses under Sec. 704(c)

1. The General Rule

Each time a partner contributes property to a partnership, IRC § 704(c)(1)(A) requires the partnership to measure the difference between the property's cost basis and its market value. The difference is hereafter referred to as "pre-contribution gains and losses" or "built-in gains and losses." Built-in gains and losses must be tracked on a property by property and a partner by partner basis.[11] When the partnership disposes of any property that contains built-in gain or loss, the gain or loss must be specially allocated to the contributing partner before any remaining gain or loss is allocated to all partners according to their partnership interests. The purpose of this rule is to prevent artificial shifting of tax consequences among the partners.[12]

EXAMPLE

> Dad contributes his Dell Computer stock with a tax basis of $1 and a market value of $10,000 in return for a 50 percent interest in the DS Family Limited Partnership. Son contributes land worth $10,000 with a basis of $10,000. Dad's built-in gain on the date of contribution is $9,999 ($10,000 - $1). If the partnership sells the stock for $12,000, the pre-contribution gain of $9,999 is allocated to Dad. The remaining $2,000 post-contribution gain is allocated 50-50 between Dad and Son.[13]

To ameliorate some of the recordkeeping with multiple partners, properties, and transactions, the regulations allow certain types of property to be aggregated. These include depreciable property other than real estate, zero basis property, inventory, and other property designated by the Service in rulings from time to time.[14] The regulations also allow the partnership to ignore

[10] Estate of Sarah D. Holliday, et al., TC Memo 2016-51.
[11] Reg. § 1.704-3(a)(2).
[12] Reg. § 1.704-3(a)(1).
[13] Reg. § 1.704-1(b)(5), Example 13(i).
[14] Reg. § 1.704-3(e)(2).

"small disparities" between value and basis.[15] A small disparity exists when the difference between the basis and market value of all property contributed by a single partner in a tax year is no more than 15 percent of the tax basis of all such property and that difference for all properties is no more than $20,000. These exceptions are little help to the typical family partnership with investment assets where the disparity is nearly always greater than 15 percent or $20,000.

If the partnership has or will make a § 754 election when a partner dies, it may seem pointless to keep track of pre-contribution gains and losses for the decedent. Upon a partner's death, the § 754 election adjusts the decedent's basis in partnership assets to the date of death value, effectively eliminating any difference between the deceased partner's inside and outside basis and any resulting gain or loss. In effect, the § 754 election "wipes out" any allocation of pre-contribution gain or loss under § 704(c) with respect to the deceased partner.[16] However, the § 754 election has no effect on the other partners.[17] Therefore, it is important to keep track of their pre-contribution gains and losses. Distributions and other transactions with the partnership continue to have direct tax consequences for them.

2. Partnership Interests Acquired by Gift

When a partner gifts a partnership interest to a family member, the donee succeeds to the donor's outside and inside basis, including any pre-contribution gains and losses.

a. Pre-Contribution Gains

When a partner transfers a partnership interest, by gift or otherwise, the built-in gain under § 704(c) attributable to that interest also transfers to the transferee partner.[18] Built-in losses are transferred under this same rule, but only for contributions of built-in loss property made on or before October 22, 2004.[19] Depending on how a partner acquires his partnership interest, his profit and loss sharing ratio may differ from his allocation of built-in gains and losses. This occurs when a partner acquires his interest partly by gift and partly by his own contributions.

EXAMPLE

Dad contributes Dell Computer stock with a basis of $1 and a fair market value of $10,000 and Son contributes $10,000 land to a family limited partnership. Shortly thereafter, Dad gifts half of his 50 percent interest to Son. The partners' capital accounts immediately afterward are:

	Market Value	Tax Basis
Dad – 25%	$ 5,000	$ .50
Son – 75%	15,000	10,000.50
Total	$ 20,000	$ 10,001.00

[15] Reg. § 1.704-3(e)(1).
[16] Reg. § 1.743-1(j).
[17] Reg. § 1.743-1(j)(1).
[18] Reg. § 1.704-3(a)(7).
[19] IRC § 704(c)(1)(C), added by the American Jobs Creation Act § 833; *see* discussion at Section II.C.3. *infra*.

Dad's gift also transfers half of his § 704(c) built-in gain as follows:

	704(c) Gain Before the Gift	Net Change	704(c) Gain After the Gift	%
Dad	9,999.00	-4,999.50	4,999.50	50
Son	-0-	4,999.50	4,999.50	50
Total	9,999.00	-0-	9,999.00	100

If the Dell Computer stock is sold immediately after the gift, the § 704(c) gain is allocated 50-50 between Dad and Son. However, any post-contribution gain would have been allocated 25-75 between Dad and Son. Next, assume instead of acquiring his partnership interest by contribution to the partnership, Son acquires his interest by gift from Dad and Mom.

EXAMPLE

Assume Dad and Mom form the partnership with jointly owned property consisting of $10,000 in cash and Dell stock worth $10,000 and with a basis of $1. Then they gift a 50 percent interest to son. The partners' capital accounts after the gift are:

	Market Value	Tax Basis	§ 704(c) Gain
Dad & Mom	$10,000	5,000.50	4,999.50
Son	$10,000	5,000.50	4,999.50
Total	$20,000	$10,001	9,999.00

In this case, Son's basis in his interest is the same as Dad and Mom's.[20] He also acquires the § 704(c) built-in gain allocable to the gifted interest. In essence, he steps into Dad and Mom's shoes as the contributing partner with respect to their pre-contribution gain under § 704(c).

b. Pre-Contribution Losses on Property Contributed Before October 22, 2004

Section 704(c) also applies to built-in losses, but only for assets contributed on or before October 22, 2004. Built-in losses on assets contributed after October 22, 2004 are subject to special rules and need to be tracked separately.[21]

[20] IRC § 1015(a).

[21] IRC § 704(c)(1)(C) (added by the American Jobs Creation Act of 2004, P.L. No. 108-457, § 833); *see* discussion at Section II.C.3. *infra*.

EXAMPLE

Dad bought Coca-Cola stock for $70,000. In 2003 Dad contributed the stock to a partnership when it was worth only $40,000. He has a built-in loss under § 704(c) of $30,000. Shortly afterward, he gave Son a 50 % partnership interest. The partnership then sells the stock for $50,000 resulting in a $20,000 tax loss for the partnership.

	704(c) Loss Before the Gift	Gift of 704(c) Loss	704(c) Loss After the Gift	%
Dad	(30,000)	15,000	(15,000)	50
Son	-0-	(15,000)	(15,000)	50
Total	(30,000)	-0-	(30,000)	

The $20,000 tax loss is shared according to the partners' § 704(c) built in losses, or $10,000 to Dad and $10,000 to Son. Dad has shifted a capital loss to his Son by making the gift in the form of a partnership interest.

3. Contributions of Built-in Loss Property

The American Jobs Creation Act of 2004 enacted new § 704(c)(l)(C), which allows only the contributing partner to use pre-contribution losses on property contributed after October 22, 2004.[22] Therefore, the partnership needs to track built-in loss property contributed after this date separately. There is no de minimis exception for small built-in losses. Note that a mutual fund might avoid the problem of tracking multiple built-in losses on contributed property, assuming it is treated as a single property. The proposed regulations provide that the rules will apply to partnership contributions and transactions occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.[23]

If the contributing partner's partnership interest is transferred or liquidated, the built-in loss is *eliminated* (emphasis added)."[24] This is a stark contrast to the "step-in-the-shoes" rule under § 704(c) for transfers of built-in loss property before October 22, 2004 discussed above. Thus, the current regulations are invalid for contributions of built-in loss property after October 22, 2004 to the extent they allow a contributing partner's built-in losses to be allocated to the transferee partner.[25] The limitation on transferring built-in losses applies to sales as well as gifts of partnership interests, but not transfers in non-recognition transactions.[26]

To carry out its purpose, the new statute provides a special basis rule for the transferee partner.[27] To compute the transferee's gain or loss, the basis of contributed property in the hands of the partnership is deemed to be its fair market value on the date of its contribution. When one considers that pre-contribution gains and losses are tracked on partner by partner, property by

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[22] IRC § 704(c)(1)(C)(i).
[23] Prop. Reg. § 1.704-3(a)(3)(iii).
[24] Prop. Reg. § 1.704-3(f)(3)(iii).
[25] Reg. § 1.704-3(a)(7).
[26] Prop. Reg. § 1.704-3(f)(3)(iii)(B).
[27] IRC § 704(c)(1)(C)(ii).

property basis, this new requirement adds another layer of complexity to partnership bookkeeping.[28] It can also have a draconian effect for gifts of partnership interests with built-in loss property contributed after the date the final regulations are published.

EXAMPLE 1

> Dad contributed built-in loss property with a basis of $11,000 and a value of $5,000 to Partnership PRS and B and C each contributed $5,000 cash. Dad gifts his interest to D. But D does not succeed to any of Dad's built-in loss in the property. Instead, the $6,000 built-in loss is eliminated as to D.[29]

D's basis for calculating his share of the gain or gain or loss on sale of the property by the partnership is its market value on the date of contribution by Dad, or $5,000. If the partnership sells the property, D reports his pro rata share of the gain or loss using a $5,000 inside basis for the property.

Note that the $6,000 loss is not entirely eliminated. In the case of a gifted interest, the donee partner inherits the donor's basis in the partnership interest.[30] Therefore, Dad's outside basis of $11,000 transfers to D and remains there until D disposes of his partnership interest. However, D may use a basis greater than $5,000 only if he sells or disposes of his interest for more than the fair market value at the time of the gift under IRC § 1015(a). Thus, D may eventually be able to use the entire outside basis in determining his gain or loss on disposition of his partnership interest, but it is subject to the limitation under IRC § 1015(a).

4. Disproportionate Capital Contributions

A partner's basis also changes when partners make disproportionate capital contributions after the partnership is formed. Disproportionate contributions generally require all the partners' interests to change and capital accounts to be restated. In this event, the regulations require the partnership to make a "reverse § 704(c)" allocations.[31] In a reverse allocation, all partnership property is revalued and the appreciation or depreciation accruing since the last restatement becomes a separate "layer" of built-in gain or loss. This new layer is thereafter tracked on a property by property, and a partner by partner basis just like the first layer.

A reverse § 704(c) allocation is a special allocation of each partner's built-in gain or loss on partnership property accruing since the date of the last capital account restatement. However, if it did not arise from a partner's contribution of built-in gain or loss property, it is not subject to the new prohibition on transferring built-in losses for property contributed after October 22, 2004[32] or the mixing bowl rules.[33] Nonetheless, it still impacts the partners when partnership interests change because of disproportionate capital contributions. However, a detail discussion of reverse 704(c) allocations is beyond the scope of this paper.

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[28] Reg. § 1.704-3(a)(2).
[29] Prop. Reg. § 1.704-3(f)(3)(iii)(C), Ex. 5.
[30] IRC § 1015(a).
[31] Regs. §§ 1.704-1(b)(2)(iv)(f), 1.704-3(a)(6).
[32] *See* discussion at Section II.C.3. *infra*.
[33] *See* discussion at Section IV.C. *infra*.

III. THE SECTION 754 ELECTION

When a partner dies, the basis of his partnership interest is adjusted to its fair market value on the partner's date of death or the alternate valuation date, if applicable, less any income in respect of a decedent attributable to the partnership interest.[34] In addition, the estate or successor partner receives a long-term holding period in his partnership interest.[35] But this only affects the decedent's or his successor's partnership interest and has no effect on the underlying partnership property. Thus, if the partnership sells an asset immediately after a partner dies, the partner's estate or other successor will report gain as if no basis adjustment occurred as a result of the decedent partner's death.

However, if the partnership makes a § 754 election, the estate or successor partner adjusts his share of the *inside* basis of partnership assets to equal its outside basis. The successor partner acquires a basis in his share of the underlying partnership assets as if he had purchased an undivided interest in them at market value on the date of death. It has no effect on the holding period or the basis of any other partner.[36]

Where the executor elects out of the estate tax in 2010, the outside basis of the decedent's partnership interest will be the carryover basis, plus any special basis increase that the executor allocates to it under § 1022(b) and (c). But the § 754 election may be ineffective to adjust the inside basis of the partnership assets. That is because Revenue Procedure 2011-41 reinforces the notion that property transferred by a decedent whose executor elected out of the estate tax under § 1022 is treated as a transfer by gift. A gift is not a transfer by sale or exchange or by death that would give rise to a § 743 basis adjustment. Therefore, it is doubtful that the inside basis of the partnership assets would be adjusted to the outside basis of the partnership interest for a decedent whose executor elected out of the estate tax.

The inside basis increase allows the successor partner to recognize a smaller share of gain or a larger share of loss than his fellow partners when the partnership sells the assets on hand at the decedent's date of death. He can also claim higher depreciation deductions than his partners based on his higher inside depreciable basis. The increase is treated as newly-purchased recovery property placed in service when the transfer (death) occurs.[37] Any applicable recovery period and method may be used. Therefore, conventional wisdom usually suggests making the § 754 election on the death of a partner.

However, the § 754 election can be a two-edged sword. First, the recordkeeping can be a burden. Second, it causes a step-down as well as a step-up in basis for the successor partner if the partnership assets are worth less than their tax basis on the date of the transfer. For example, a § 754 election is not desirable when discounts on the outside partnership interest would reduce the decedent's share of inside basis of partnership assets to below his share of their cost basis. Third, the election is irrevocable without the consent of the IRS. Thus it causes inside basis adjustments at each subsequent partner's death whether the partners desire it or not. And fourth, it requires

[34] IRC § 1014(a)(1); Reg. § 1.742-1; *see also* discussion at Section II.D. *infra*.
[35] IRC § 1223(9).
[36] Reg. § 1.743-1(j)(1).
[37] Reg. § 1.743-1(j)(4)(i)(B); On the other hand, any decrease in the basis of depreciable property under a § 754 election is recovered over the remaining useful life of the partnership's depreciable property under Reg. § 1.743-1(j)(4)(ii)(B).

the partnership to adjust the basis of its assets when it makes certain types of distributions.[38] In short, it affects every partner from that point forward.

A. Who Can Make the Election

A § 754 election can only be made if the partner dies, there is a distribution of property to a partner, or there is a transfer of a partnership interest by sale or exchange.[39] A distribution of a partnership interest is a sale or exchange for purposes of § 754.[40] Accordingly, a distribution of a partnership interest by an estate or trust should allow the partnership to make a § 754 election and step up the inside basis of the assets. The Senate Report to the 1986 Tax Reform Act explains that distributions of partnership interests are sales or exchanges for purposes of §§ 708, 743, and any other partnership provision specified in the regulations.[41] It further provides that the Secretary may provide exceptions to this rule, such as distributions of a partnership interest by an estate or testamentary trust by reason of the death of a partner. However, the IRS has not published any regulations excepting distributions from an estate or trust from sale or exchange treatment for purposes of § 743.

Another special issue arises when the decedent owned a partnership interest through a QTIP marital trust. Under pre-2010 law the QTIP assets are included in the decedent's gross estate under § 2044. The partnership interest is treated as passing from the decedent under § 2044. Thus there has been a transfer by death, which enables the partnership to make a § 754 election to step up the inside basis of the partnership assets to the decedent partner's outside basis.[42] However, if the partner dies in 2010, the QTIP assets are not included in the decedent's gross estate because there is no estate tax and § 2044 does not apply. This means there has been no transfer by death under § 743(a), and the partnership cannot adjust the inside basis of the partnership assets.

B. Mechanics: The Hypothetical Sale

The outside basis in the decedent's partnership interest is adjusted to the value on the partner's date of death, or the alternate valuation date, if applicable, regardless of whether a § 754 election is made.[43] The basis increase will eventually provide a tax savings for the successor when the partnership interest is sold or liquidated. However, wanting to reap the tax benefits of a basis step-up sooner, many partnerships make the § 754 election. This pushes the outside step-up or step-down to the inside basis of the partnership assets with respect to the decedent partner's interest. Thus, sales of property occurring fairly soon after death will result in little or no gain to the successor partner due to the § 754 basis adjustment.

The regulations provide how to allocate a transferee's basis in his partnership interest among his share of the underlying partnership assets when the partnership makes a § 754 election.[44] The goal of § 754 is to achieve uniformity between the inside and outside basis when there has been a transfer of a partnership interest by sale or exchange or upon the death of a partner. Stated

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[38] IRC 734(b).

[39] IRC §§ 734(a), 743(a).

[40] IRC § 761(e).

[41] S. Rep. 313, 99th Cong., 2nd Sess., 1986-3 C.B. Vol. 3 924.

[42] PLR 200442028.

[43] IRC § 1014(a).

[44] Regs. §§ 1.743-1, 1.755-1.

another way, a transferee partner of a partnership that made a § 754 election should have the same basis in his share of the underlying partnership assets as if he had purchased an undivided interest in them. To achieve this goal, regulations provide a three-step process.

Step One - Determine the difference between the partner's basis of his partnership interest and his share of the adjusted basis of partnership property.[45] This difference is the § 743 adjustment. The basis of a purchased interest is its cost. The basis of an interest acquired from a decedent is the fair market value at the date of death or the alternate valuation date.[46]

Step Two – Separate the adjustment into two classes - ordinary income and capital gain property. [47]Apply the adjustment first to ordinary income property in an amount equal to the income that would be allocated on sale of that asset at fair market value. Apply the remaining balance of the adjustment to the capital gain class. One class may get a step-up in basis and another class may be allocated a step-down. [48]

Step Three - Allocate the step-up or down for each class among the assets within each class on an asset by asset basis based on the taxable gain or loss that would be allocated to the transferee from the "hypothetical sale" of each item. [49]

EXAMPLE

Joe died with an interest in partnership that has only marketable securities. His partnership interest is valued at $17,500 based on a hypothetical sale of his share of the underlying assets. His share of the basis in those assets is $11,200. The Section 743 adjustment is $6,300 ($17,500 – 11,200) and is allocated as follows:

	Basis before 743 Adj	FMV	§ 743 Adj.
Stock A	6,000	2,000	-4,000
Stock B	1,800	9,200	+7,400
Stock C	3,300	2,800	- 500
Stock D	100	3,500	+ 3,400
Total	$11,200	17,500	6,300

C. Applying Partnership Discounts

A "hypothetical sale" of the underlying partnership assets will always produce a higher value than a sale of a discounted minority interest in them. Thus the question arises how to allocate valuation discounts among the partnership assets. The regulations provide an example of a partner who sells his interest for less than fair market value, which would be similar to a

[45] Reg. § 1.743-1(b)-(d).
[46] Reg. § 1.742-1.
[47] Reg. § 1.755-1(a).
[48] Reg. § 1.755-1(b)(2).
[49] Reg. § 1.755-1(b)(3).

discount based on restrictions in the partnership agreement.[50] In the example, the discount is allocated to the partnership's capital gain assets based on each property's relative fair market value as a percentage of all the capital gain assets.[51]

EXAMPLE

Joe died with an interest in partnership that has only marketable securities. His share of the underlying assets is worth $17,500 based on a hypothetical sale of those assets. However, an appraiser values his interest at $14,000 based on discounts for lack of marketability and control. Joe's share of the basis in those assets is $11,200. The total gain that would be allocated from a hypothetical sale of those assets is $6,300 ($17,500 – 11,200). However, this exceeds the total basis adjustment required under § 743 by $3,500 ($17,500 - $14,000), which is the amount of the discount. Therefore, the $3,500 discount and is allocated as follows:[52]

	Basis before 743 Adj	FMV	§ 743 Adj.	Discount Allocated	Adjusted Basis
Stock A	6,000	2,000	-4,000	-400[53]	$ 1,600
Stock B	1,800	9,200	+7,400	-1,840	7,360
Stock C	3,300	2,800	- 500	-560	2,240
Stock D	100	3,500	+ 3,400	-700	2,800
Total	$11,200	17,500	6,300	-$ 3,500	$14,000

Stated more simply, each asset derives a new basis equal to a fraction of the total discounted value based on each asset's fair market value as it relates to the total fair market value. In the example above, Stock D comprises 20 percent of the total fair market value ($3,500/$17,500 = 20%). Therefore, Stock D has a new basis under § 743 of $2,800, or 20 percent of $14,000.

D. Community Property

A § 754 election permits an adjustment to be made under § 743(b) to the basis of partnership property "...in the case of a transfer of an interest in a partnership by sale or exchange or on the death of a partner." In community property states the surviving spouse's one-half community interest in the partnership is not "transferred" upon the decedent's death because the surviving spouse owns it to start with.[54] However, by statutory grace, the survivor obtains a basis adjustment under § 1014(b)(6). Despite that the § 754 election should not literally apply to the surviving spouse's community property interest in the partnership, the IRS has ruled that the § 754 optional basis adjustment applies to the entire partnership interest owned as community property, including the surviving spouse's share.[55] The same result applies if the nonpartner

[50] Reg. § 1.755-1(b)(3)(iii), Ex. 2.
[51] Reg. § 1.755-1(b)(3)(iii), Ex. 2.
[52] *Id.*
[53] $2000/$17,500 X $3,500 = $400.
[54] Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states.
[55] Rev. Rul. 79-124, 1979-1 C.B. 224.

spouse predeceases the partner spouse.[56] While seemingly incorrect, the ruling is favorable to the taxpayers and solves the accounting problems that arise from a bifurcated basis attributable to the surviving spouse's partnership interest.

E. When Not to Make the Election

If the discounted value of the partnership interest is less than the partnership's cost basis in the underlying assets, the partnership should not make the § 754 election. If made, the election will reduce the decedent partner's share of the cost basis of the partnership assets to the discounted amount. However, for deaths occurring after October 22, 2004 the partnership will be forced to make a downward adjustment if the cost basis of all the partnership property exceeds its fair market value by more than $250,000.[57]

EXAMPLE

DMS partnership has marketable securities with a cost basis of $100,000 and a market value of $150,000. An appraisal applies a 50 percent discount, valuing the partnership at $75,000. D, a 20 percent partner, dies and DMS makes § 754 election. D's new basis on his date of death is $15,000, or 20 percent of $75,000. After his death, DMS sells the stock for $150,000. The tax consequences to D's successor are:

	With § 754 Election	Without § 754 Election
Sales Proceeds allocable to D (20% X $150,000)	30,000	30,000
D's Stock Basis		
(20% X $75,000)	-15,000	
(20% X $100,000)		-20,000
Gain Recognized	$15,000	10,000

In the above example, the § 754 election brings the discount inside the partnership causing D to report an extra $5,000 in gain. But this is only a timing difference. D's successor adds the $5,000 gain to his outside basis and reduces his gain when he later disposes of his interest.

	With § 754 Election	w/o § 754 Election
D's Basis in Pship	15,000	15,000
Gain recognized	15,000	10,000
Liquidation Distr.	-30,000	-30,000
Gain on Liquidation	-0-	5,000

However, timing differences matter, especially if the partnership does not plan to cash out the successor partner right away and the partnership will sell assets soon after the decedent's

56 *Id.*

57 *See* discussion at Section III.F. *infra.*

death. The partnership should base its decision whether to make a § 754 election on how soon after the decedent's death the assets will be sold. The more likely the partnership will sell them soon after the decedent's death, the more likely the § 754 election will be beneficial.

If the IRS is currently auditing or likely to audit the decedent's Form 706, it may be difficult to decide whether to make the § 754 election. Any reduction in the discount will affect the basis of partnership assets when a § 754 election is in effect. A partnership that did not make the election because the cost basis of its assets exceeded the discounted value may regret that decision if the IRS reduces the discount so that the discounted value exceeds the inside cost basis. In that case a § 754 election would have been desirable. However, taxpayers should evaluate the § 754 election independently of the potential consequences of an IRS audit.[58] First, it is impossible to predict whether the Form 706 will be audited and what the outcome will be. Second, the partnership and partners can amend their income tax returns if they are within the three-year statute of limitations. Third, the partners may be entitled to equitable relief if they are beyond the statute of limitations for amended returns.[59]

Unless the § 754 election will produce significant benefits, it should probably not be made because of its impact on the remaining partners. For example, if the partnership redeems the estate shortly after death, the estate will receive a new basis in the assets distributed equal to the estate's outside basis in the partnership interest. Thus there would be no need for a 754 election. If the partnership does not plan to sell any of its major assets anytime soon, a step-up on the inside basis produces no immediate tax savings. In both cases, if the partnership had made the election, it would achieve little or no income tax benefit, while causing significant impact on the remaining partners for the duration of the partnership. Thus, where the estate's interest is very small or assets will not be sold or depreciated, the partnership should probably not make the election. This decision can be one of the hardest decisions a partnership can make.[60]

F. Mandatory Basis Adjustments for "Substantial Built-in Loss Property"

Basis adjustments under § 743 are mandatory when a partner dies or transfers by sale or exchange an interest in the partnership that has a "substantial built-in loss." A substantial built-in loss exists if the adjusted basis of partnership property exceeds the property's market value by more than $250,000 on the date of the death or transfer. If the partnership is required to make a mandatory basis adjustment because of a substantial built-in loss, it must check a box on Form 1065, Schedule B and attach a statement showing the computation and allocation of the basis adjustment.

Note that the $250,000 is the difference between the cost and market value of the partnership *property,* not the partnership interest. But once this threshold is met, the required adjustment is the difference between the cost of the partnership property and the discounted value of the partnership interest, which could be significantly larger than the spread between the cost and market value of the partnership assets.

[58] *Id.*

[59] Jorgensen v. Comm'r, T.C. Memo 2009-66 (Mar. 26, 2009), *aff'd* 107 AFTR 2d 2011-2069 (9th Cir 2011).

[60] *See* Exhibit B, Section 754 Decision Tree *infra.*

1. The $250,000 Threshold

The partnership measures the $250,000 on a "net" basis with respect to the entire partnership, rather than on a per asset basis. Thus, the partnership could have significant built-in losses and escape the rule as long as it has sufficient built-in gains to offset the losses to below $250,000. The statute applies the $250,000 test on a partnership by partnership basis. Thus, it may apply to a parent but not to its subsidiary partnership. Nonetheless, the value and basis of a subsidiary partnership is part of the gain or loss measured at the parent level. Anticipating potential abuse in this area, Congress authorized the IRS to write regulations aggregating related partnerships.[61] Congress anticipated that taxpayers might be tempted to transfer property to a partnership just before a death or sale of the interest to avoid these rules. Therefore, Congress also granted the IRS regulatory authority to disregard property acquired by the partnership in anticipation of a transfer or death.[62]

There are many unanswered questions about how to figure a partnership's basis in its property under IRC § 743(d). For example, do § 754 adjustments count as part of the basis of the partnership assets? Also, is the basis of built-in loss property contributed after October 22, 2004 its basis or market value on the contribution date?[63]

The estate's alternate valuation election does not affect the determination of whether a partnership has a substantial built-in loss. Section 743(d) measures the difference between the basis and the market value of the partnership assets on the date of death or transfer. It makes no reference to the alternate valuation date. Once the partnership determines that it has a substantial built-in loss on the date of death, the *amount* of its mandatory basis adjustment under § 743(b) depends upon whether the estate elects AVD. It is also important to note that the partnership calculates the built-in loss, but the estate makes the AVD election, and they have different compliance deadlines. Therefore, it might be impractical to make the partnership's determination of whether it has a substantial built-in loss depend on whether the executor elects AVD.

2. The Mechanics

Once the partnership determines that it has a substantial built-in loss on the date of a sale, exchange, or death of a partner, the size of the adjustment depends on the distributee's outside basis. The partnership must adjust, up or down, the basis of individual partnership assets with respect to the transferee to equal the transferee's outside basis in his partnership interest. The adjustment is allocated among the assets as if the transferee purchased an undivided interest in each one. A sale or exchange of any size, or the death of any partner, requires this adjustment with no de minimis rule. The adjustment affects only the transferee partner.

EXAMPLE

Dad died with a 25 percent interest in a family partnership with assets worth $4,000,000 and a basis of $4,300,000. The partnership has a substantial built-in loss because the property's basis exceeds its market value by more than $250,000.

[61] IRC § 743(d)(2).
[62] *Id.*
[63] *See* discussion at Section II.C.3. *infra.*

	(a) FMV of Partnership Assets	(b) Cost of Partnership Assets	(a) – (b) Substantial Built-in Loss
Total	$ 4,000,000	$ 4,300,000	(300,000)

The partnership must reduce the decedent's share of the inside basis of partnership assets as if the partnership had made a § 754 election, even though the partnership would not have made the election voluntarily. In the example above, if the partnership sells its assets for $4,000,000 the other partners would report their share of the loss. However, the estate's basis has been reduced by its share of the built-in loss and thus is not entitled to report any share of the loss.

3. Partnership Discounts and the $250,000 Threshold

The question arises how valuation discounts impact the new mandatory basis rules. Section 734(d) asks us to measure the difference between the partnership's basis and fair market value of its property. For this purpose, it is irrelevant what the partner's basis in his partnership interest is. However, once the partnership determines that it has a substantial built-in loss, the transferee/decedent partner's basis in his partnership interest determines the amount of the mandatory basis adjustment made on the partnership books.[64]

EXAMPLE

Dad died with a 25 percent interest in a family partnership that has assets worth $4 million and a basis of $4.3 million. The partnership has a substantial built-in loss of $300,000.[65] Therefore, it must reduce the estate's share of the inside basis of the partnership assets to the value of the estate's partnership interest, which the executors valued at $700,000 using a 30 percent discount. The mandatory downward adjustment for the estate is therefore $375,000 [$1,075,000 - $700,000].

	(a) FMV of Pship Assets	(b) Basis of Pship Assets	(a) – (b) Difference	(c) Outside Basis of Pship Interest	(b) – (c) Mandatory Step Down
Total	$4,000,000	$4,300,000	(300,000)	$2,800,000	
Dad's 25%	$1,000,000	1,075,000	(75,000)	700,000	$ 375,000

Therefore, even though partnership discounts do not affect the $250,000 threshold, they may affect the size of the mandatory basis adjustments the partnership is required to make once it passes the threshold. Further, because discounts are apt to change upon an IRS audit, the partnership may not be sure how much of an adjustment to make. For example, assume the partnership sells property and reports gain or loss to the transferee partner based on the mandatory adjustments. If the mandatory adjustments subsequently change because the discounts change, the partnership and the transferee partner(s) would need to amend their income tax

[64] IRC § 743(b)(2).

[65] Adapted from Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005).

returns to report the correct gain or loss. They should be careful to do so before the statute of limitations expires, which is generally three years from the extended due date of their original returns. These adjustments apply only to the transferee partner and his successors.[66]

If a partnership has a built-in loss exceeding $250,000, and the death of a major partner is imminent, the partnership might consider selling assets to recognize losses before the partner dies. Alternatively, the partner might consider gifting all or a portion of his partnership interest to a family member to transfer his built-in losses to the donee under § 704(c).[67] This applies to all built-in losses except on property contributed after October 22, 2004.

An estate that acquires an interest in a partnership that is subject to the new mandatory basis adjustment rues must notify the partnership in writing of its acquisition within one year of the partner's death.[68] A transferee by sale or exchange has only 30 days from the transfer to notify the partnership. The partnership must attach a statement to its return in the year of a death or transfer to which these rules apply showing the computation of the adjustments and the properties to which they have been allocated.[69]

G. Recordkeeping Responsibility

The regulations require a partnership to attach a statement to its return when it becomes aware that a transfer subject to the optional basis adjustment rules has occurred.[70] The statement must contain the partner's name, taxpayer ID number, and a computation of the partner's adjustment under § 743(b). Transferees (i.e. purchasers or successors in interest) must notify the partnership of the basis in their acquired interest.[71] Transferors have no obligation to report the transfer. When a partner dies, the successor partner must notify the partnership within one year of death.[72] Partnerships may rely on written representations of transferee partners concerning either the amount paid or the basis in the partnership interest acquired from a decedent.[73]

H. Impact of § 754 on Other Partners

The § 754 basis adjustments not only affect a transferee partner's basis, they also affect the basis of the partnership's assets under any of the following four situations:

(a) A partner receives money (or securities) in excess of his partnership basis;[74]
(b) A partner receives only money (or securities), unrealized receivables, and inventory in complete liquidation of his interest and the total of these items is less than his remaining basis in his partnership interest;[75]
(c) A partner receives property that has an adjusted basis in excess of the partner's basis in his

[66] Reg. §§ 1.743-1(f), (j)(1).
[67] *See* discussion at Section II.C.2.
[68] Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005); Reg. § 1.743-1(k)(2)(ii).
[69] Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005); Reg. § 1.743-1(k)(l).
[70] Reg. § 1.743-1(k)(1).
[71] Reg. § 1.743-1(k)(2).
[72] Reg. § 1.743-1(k)(2)(ii).
[73] Reg. § 1.743-1(k)(3).
[74] IRC §§ 731(a)(1), 734(b)(1)(A).
[75] IRC §§ 731(a)(2), 734(b)(2)(A).

partnership interest;[76] and

(d) A partner receives property in a liquidating distribution and the property's basis is less than the partner's basis in his partnership interest;[77]

In situations (a) and (c) the partnership must increase the basis of assets remaining on its books. In situations (b) and (d), the partnership must reduce the basis of assets remaining on its books. Note that the American Jobs Creation Act of 2004 made these basis adjustments mandatory for deaths and transfers after October 22, 2004 where the partnership has a built-in loss greater than $250,000, despite the absence of a § 754 election.[78] The Jobs Act also made the negative adjustments mandatory for distributions after October 22, 2004 if the amount of the adjustment required if a § 754 election had been in effect would have exceeded $250,000.[79]

The following illustrates the adjustment to partnership property if a § 754 election is in effect when the partnership makes a liquidating distribution of property, the basis of which exceeds the partner's basis in his partnership interest (situation (c) above):

EXAMPLE 1

> D, M, and S form DMS, a family partnership with a § 754 election in effect. D and M each contribute Properties A and B for a one-third interest in the partnership. Properties A and B each have a basis of $40 and a FMV of $100. S contributes land with a basis and fair market value of $100 for a one-third interest. Seven years later the land, still worth $100, is distributed to D in liquidation of his interest.

The partnership's basis in the land is $100. However, upon distribution, its basis to D is limited to D's $40 basis in his partnership interest.[80] Without a Section 754 election, no adjustment is made to the partnership's remaining assets and $60 of the land's basis disappears into thin air. If, however, the partnership had a § 754 election in effect in the year of the distribution, the basis of DMS's remaining assets would be stepped-up by $60 to make up for the disappearing land basis.

Example 1 creates basis for the partnership. Contrast it with Example 2 below which eliminates partnership basis (situation (d) described above):

EXAMPLE 2

> Assume the same facts as Example 1 except that the partnership distributes Property A to S in liquidation of his interest (instead of D). Property A, worth $100, has a basis of $40 basis, but it assumes a new basis in the hands of S equal to S's basis in his partnership interest, or $100.[81]

If the partnership had a § 754 election in effect in the year of the distribution, the basis of

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[76] IRC §§ 732(a)(2), 734(b)(1)(B).
[77] IRC §§ 732(b), 734(b)(2)(B).
[78] P.L. 108-457, § 833.
[79] *Id.*
[80] IRC § 732(b).
[81] *Id.*

DMS's remaining assets would be stepped-up down by $60 to make up for the basis increase that S enjoyed. Absent a § 754 election in effect, no adjustment is made to the basis of the partnership's remaining property. In effect, $60 of basis has been created for Property A with respect to S. In addition, the partnership retains the high basis land. This is exactly the type of practice the American Jobs Creation Act sought to curtail after October 22, 2004.[82]

Keep in mind that these adjustments are only temporary. When the partnership interest is liquidated and the assets are distributed or sold, the proper amount of gains and losses will be recognized by the proper parties regardless of whether the partnership made a § 754 election. The only difference is the timing. The main point is to anticipate the impact a § 754 election will have on future transactions and weigh the current benefits to the deceased partner of a § 754 election against any potentially detrimental basis adjustments impacting the remaining partners.

I. Making the Election

To make the election the regulations require the partnership to attach a written statement, signed by one of the partners, to its timely filed return (including extensions) for the year in which the partner died or the transfer occurred.[83] The partnership should also check the box on line 12a of Form 1065, Schedule B, indicating that it is making the election. Checking the box is not a substitute for attaching a written election statement. Nor is it enough to reflect the adjustments to basis as if the election were in place. The election must actually be made.[84]

The IRS gives independent effect to each partnership's § 754 election (or lack thereof). Thus, a parent's § 754 election is not effective for the lower tier partnership. It must make a separate election.[85] However, where a lower tier partnership inadvertently fails to make a § 754 election, the IRS has granted it relief where the upper tier partnership made a timely election.[86] If both an upper and lower-tier partnership make a § 754 election, the upper-tier's election causes a basis adjustment of property for both tiers.[87] If only the lower-tier partnership makes a § 754 election, no basis adjustment is available at either level.[88] In other words, to adjust the basis of the lower tier partnership's assets, both tiers must make the election.

1. Late Elections

If the due date for a § 754 election has passed, the partnership can still make the election by filing an original or amended return within twelve months of the due date, including extensions, of the return year for which the election is sought. The partnership should print: "**FILED PURSUANT TO REG. 301.9100-2**" on the top of the election. No user fees apply.[89] Thus the partnership can make an election effective for 2016 as late as September 15, 2018, which is one year from the final extended due date of September 15, 2017.

[82] P.L. 108-457, § 833.
[83] Reg. § 1.754-1(b).
[84] Ltr. Ruls. 200901015, 200903068, 200901016.
[85] Rev. Rul. 87-115, 1987-2 C.B. 163.
[86] Ltr. Ruls. 9338004, 9338005, 9338006, 9327068.
[87] *Id.*
[88] Rev. Rul. 87-115, 1987-2 C.B. 163; *See also* McKee, Nelson, & Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, Third Edition (Warren, Gorham & Lamont, 2004) ¶24.09.
[89] Reg. § 301.9100-2(d).

Failure to qualify under the automatic extension provisions of Reg. § 301.9100-2 is not the last stop. But it's the last quick or cheap stop. Taxpayers ineligible for the automatic extension may still request a late § 754 election under Reg. § 301.9100-3. Permission is not automatically granted by the Commissioner and carries a $10,000 user fee.[90] The partnership must have acted reasonably and in good faith and the relief must not jeopardize the interest of the government.

The IRS has been generous in granting relief for late § 754 elections where the failure was due to complications of administering the estate, extended litigation,[91] reliance on accountants who made an error or failed to properly inform them,[92] preparation of the election statement, but failure to attach it to the return,[93] and simple inadvertence, where the taxpayer acted in good faith.[94] While the IRS has been lenient on granting rulings for late elections, a ruling requires a $9,800 user fee (reduced to $2,200 and $6,500 for taxpayers with AGI less than $250,000 and $1,000,000) and takes significant professional time to complete.[95]

If several years are closed under the statute of limitations, the IRS has denied relief.[96] It has also denied a late election where it was made after the IRS included partnership assets in the decedent's estate under § 2036. The LLC had not made the § 754 election on the original return because "the benefit it provided did not outweigh the complexity of creating multiple bases."[97]

2. Revoking the Election

Once made, the election is irrevocable without the approval of the district director for the district in which the partnership return is required to be filed.[98] A request for revocation must be filed within 30 days after the partnership year end for which the election is intended to be effective, usually the tax year within which the partner died.[99] The IRS will approve a request for reasons such as a change in the nature of the partnership business, a change in the character of the partnership assets, or an increased frequency of shifts of partnership interests where a 754 election would increase the administrative burden on the partnership. A revocation will not be approved if its primary purpose is to avoid stepping down the basis of partnership assets.

If the partnership is beyond the 30 day revocation period under Reg. § 1.754-1(c), it can seek relief for a late filed revocation under Reg. § 301.9100-1, which defines the standards for relief under Reg. § 301.9100-2.[100] The partnership will need to pay a $9,800 user fee and

[90] Rev. Proc. 2016-1, 2016-1 I.R.B., Appendix A.

[91] Ltr. Ruls. 200531016, 200530015.

[92] Ltr. Ruls. 201532014, 201102025-26, 201012031, 201011004, 201012032, 200906026.

[93] Ltr. Rul. 200802001.

[94] Ltr. Rul. 201610002, 201514002**.**

[95] Rev. Proc. 2016-1, 2016-1 I.R.B., Appendix A (Reduced user fees apply to individuals, estates, partnerships, corporations, and other entities whose adjusted gross income is less than $250,000 or $1,000,000.)

[96] Ltr. Rul. 9452025.

[97] Ltr. Rul. 200626003 (7/28/2006) (IRS denied relief under Reg. § 301.9100-3 for a partnership to make a late § 754 election after the decedent's Form 706 was audited and the IRS included assets contributed to the partnership in the decedent's estate under § 2036. The partnership did not make the § 754 election on the original return because at the time it did not seem that the benefits outweighed the complexity.).

[98] Reg. § 1.754-1(c).

[99] Reg. § 1.754-1(c)(1).

[100] Ltr. Ruls. 9234022, 9228018.

provide a detailed explanation of why additional time should be granted.[101] Reduced user fees of $2,200 and $6,500 apply to partnerships with AGI of less than $250,000 and $1,000,000 respectively

On the other hand, if the partnership discovers that a § 754 election was made in error, it may be possible to rescind the election based on "mistake of fact." There are no published rulings on revoking a § 754 election, prospectively or retroactively, except for a few dealing with a special one-time revocation that was permitted for certain pre-2000 requests.[102] But note that a rescission is not the same as a revocation. A revocation must be requested within 30 days of the partnership year end for which it is to be effective. Because this deadline occurs well the initial election would have been made, the procedures for revoking an election could not have been intended for revoking an initial election. If the initial election was made in error, it may be possible to amend the return and void the election from inception based on a "mistake of fact, particularly if the taxpayer received no benefit from the election."[103]

3. Division or Constructive Termination

Another way to terminate a § 754 election is to constructively terminate the partnership under § 708. A constructive termination occurs if 50 percent or more of the total interest in partnership profits and capital are sold or exchanged within a 12 month period.[104] A constructive termination ends any partnership elections that were in effect prior to the termination, including a § 754 election, except with respect to the incoming partner.[105] The termination is effective on the date of the sale or exchange, which by itself or together with sales or exchanges occurring in the previous 12 months, transfers an interest of 50 percent or more in partnership profits and capital.[106] There are no attribution rules in determining the 50 percent ownership test.

Distributions of a partnership interest by an entity are sales or exchanges for purposes of § 708, 743, and any other provision that the Secretary prescribes in regulations.[107] The sale or exchange need not necessarily be a taxable sale or exchange. The legislative history to § 761(e) provides that the Secretary may provide exceptions to this rule and that: "It is intended that exceptions might include a distribution of a partnership interest by an estate or testamentary trust by reason of the death of a partner will not be treated as a sale or exchange for purposes of § 708(b)." [108] To date the IRS has excluded the following transactions from sale or exchange treatment under § 708:

- A transfer by gift, bequest, or inheritance.[109]
- A liquidation of a partnership interest. [110]

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[101] Rev. Proc. 2016-1, 2016-1 I.R.B. 1, Appendix A, category 3(c) (for requests received by IRS after Feb. 2015).

[102] Reg. § 1.754-1(c)(2).

[103] Roy H. Park Broadcasting, Inc. v. Commissioner, 78 T.C. 1093, 1134 (1982) ("once a taxpayer makes an elective choice, he is stuck with it."); *but see* Grynberg v. Comm'r, 83 T.C. 255 (1984) (exceptions to the doctrine of election for material mistake of fact.)

[104] Reg. § 1.708-1(b)(2).

[105] Reg. § 1.708-1(b)(5).

[106] Reg. § 1.708-1(b)(1)(iii)(b).

[107] IRC § 761(e).

[108] S. Rep. No. 313, 99th Cong., 2d Sess. 924 (1986).

[109] Reg. § 1.708-1(b)(1)(ii).

- Contributions of property by new or existing partners causing a shift in partnership interests of more than 50 percent.[111]

Because these constructive termination rules serve as a "trap for the unwary or as an affirmative planning tool for the savvy taxpayer," the Administration's Fiscal Year 2017 Revenue Proposals would repeal § 708(b)(1)(B) altogether.[112]

a. Distributions of a Greater Than 50 Percent Partnership Interest

The death of a 51 percent partner and consequent transfer to his estate is not a sale or exchange that constructively terminates the partnership.[113] Nor is the transfer of a partnership interest in satisfaction of a specific bequest, according to the regulations. However, a distribution by the estate of a 51 percent partnership interest in satisfaction of a pecuniary bequest is a taxable sale or exchange under § 661.[114] It would also cause a constructive termination of the partnership and terminate the partnership's § 754 election.

However, a distribution of the partnership interest by the estate as part of the residue would not be a sale or exchange that constructively terminates the partnership because it is a transfer by inheritance, which the regulations exclude from sales or exchanges under § 708.[115] Thus it would not terminate the partnership's § 754 election. A distribution by a trust other than by reason of the death of a partner would not be a "transfer by bequest or inheritance" and thus could cause a constructive termination under § 708, even though it is not a sale or exchange.[116]

In lieu of a deemed sale, a partnership could simply dissolve in order to substitute its outside basis for its inside basis.[117] The partnership could also divide as discussed below.

b. Dividing the Partnership

A partnership can also terminate, along with its elections, by dividing into two or more partnerships, at least one of which is owned by partners who had an interest of 50 percent or less in the capital and profits of the prior partnership.[118] In this case, a resulting partnership of 50 percent or less of the prior partnership is treated as a liquidation of the partners' interests and a contribution to a new partnership.[119] Any resulting partnership that consists of partners owning more than 50 percent of the prior partnership's capital and profits is considered a continuation of the prior partnership and its elections remain intact.[120]

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[110] Reg. § 1.708-1(b)(2).

[111] *Id.*

[112] General Explanation of the Administration's 2017 Revenue Proposals, p. 246, *available at.* https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf.

[113] Reg. § 1.708-1(b)(1)(ii).

[114] Reg. § 1.661(a)-2(f)(1).

[115] Reg. § 1.761-1(e).

[116] S. Rep. No. 313, 99th Cong., 2d Sess. 924 (1986).

[117] IRC § 732(d).

[118] IRC § 708(b)(2)(B).

[119] Reg. § 1.708-1(d).

[120] *Id.*

EXAMPLE

> A, B, C, and D are each 25 percent partners in ABCD Partnership that has a § 754 election in effect. The partnership divides its assets equally into AB Partnership and CD Partnership. A and B each own a 50 percent interest in AB. C and D each own a 50 percent interest in CD. ABCD Partnership has terminated because 50 percent or more of its capital and profits has been exchanged within a 12 month period. Neither AB nor CD is owned by partners who owned more than 50 percent of ABCD Partnership. Therefore, neither AB nor CD has a valid § 754 election in effect.

A partnership wishing to terminate a § 754 election by dividing a partnership must do so before the death of the key partner. The assets for which the § 754 election is undesirable should be transferred to a new partnership that is not considered a continuation of the prior partnership under § 708. This is major surgery, but may be warranted in the right circumstances.

On the other hand, if the partnership has not already made a § 754 election and has both appreciated and depreciated assets, it should consider dividing in two. One partnership would own the appreciated assets and make a § 754 election. The other would own the depreciated assets and would not make the election. The post-division election by one partnership does not affect the other partnership.[121] One must be careful that the cost basis of the depreciated assets does not exceed their market value by more than $250,000, or else the mandatory basis adjustment rules require the basis to be stepped down.[122] In addition, it is important to complete the division and have the new partnership make a timely § 754 election. The partnership with assets having the greatest fair market value (net of liabilities) will continue to use the federal ID number of the old partnership. The other partnership must obtain a new ID number.[123]

J. New Basis Reporting Rules Under Section 6035

Executors of estates that are required to file a Form 706 because the gross estate exceeds the applicable exclusion amount ($5,450,000 in 2016) must also issue statements to the beneficiaries and file Form 8971with the IRS reporting the basis of assets distributed to those beneficiaries.[124] The basis is reported on Form 8971 and Schedule A attached thereto. It must be filed by the *earlier* of 30 days after the Form 706 is due or the date the Form 706 is actually filed with the IRS.

The executor is required to report only the basis as finally determined by the IRS.[125] Therefore, any post-death basis adjustments are not reflected in the basis statements provided to the beneficiaries. This can be problematic as many post-death adjustments significantly affect the beneficiary’s basis, such as depreciation, any gain recognized by the estate on distributing the asset to the beneficiary, etc. However, in such cases, the beneficiary is simply left to his own devices to determine his correct basis.

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[121] Reg. § 1.708-1(d)(2)(ii).
[122] IRC § 743(d).
[123] Reg. § 1.708-1(d)(2)(i); Reg. § 1.708-1(d)(4)(i).
[124] IRC § 6035.
[125] Prop. Reg. § 1.6035-1(a)(1)

K. Consequences of Overstating the Basis

Overstating the basis of an asset is an omission of gross income, which invokes the 6-year statute of limitations under § 6501(e). When a taxpayer omits an amount of gross income from a return that exceeds 25 percent of the gross income stated on the return, the IRS has 6 years from the time the return is filed to assess the tax, compared to the normal 3 year statute of limitations.

In addition, the IRS may impose an accuracy-related penalty on the portion of any underpayment attributable to reporting a basis in excess of a property's final estate tax value where the property was reported on a Form 706 that was required to be filed under IRC § 6018 (i.e. where the estate exceeded the applicable exclusion amount).[126]

L. Valuation Discounts on Account of the Election

Because mandatory basis adjustments have measurable negative consequences, a purchaser of a partnership interest would surely take them into consideration. For instance, higher discounts should apply during any seven year period in which the mixing bowl rules might apply. Additional discounts should also apply where the partnership agreement requires the partnership to make the § 754 election, or where the purchaser insists on it, because it requires extra recordkeeping. And finally, discounts should apply if the partnership has built-in loss property contributed on or after October 22, 2004 or that could be subject to mandatory basis adjustments on its distribution.[127] Even though it may be difficult to quantify the exact discount attributable to these basis adjustments, the accounting costs are real, despite their nature as timing differences. Congress thought these timing differences were significant when it enacted tough new laws to curb their abuses.

M. Partnerships Owned by a Marital Trust

When a surviving spouse dies with appreciated assets in a partnership interest owned by a QTIP trust that is included in his or her gross estate under § 2044(a), can the QTIP trust make a § 754 election to step up its share of the inside basis of the partnership assets? Some suggest that the answer is "no" because the partner (the QTIP trust) has neither sold, transferred, distributed its interest or died, which are prerequisites for the QTIP trust to adjust its share of the inside basis of partnership property under a § 754.[128] However, § 2044(c) treats property included under IRC § 2044(a) as property "passing from the decedent." Further § 1014(b)(10) treats property includible in the gross estate of the decedent under § 2044 as having "passed from the decedent" for purposes of acquiring a basis equal to the market value on the decedent's date of death.

Therefore, if the partnership interest is included in the surviving spouse's gross estate under § 2044 and is treated as "passing from the decedent" to the QTIP trust, the partnership should be eligible to make a § 754 election and adjust the QTIP trust's share of the inside basis of the partnership assets, assuming it makes a timely election. The election must be filed by the extended due date of the partnership return for the year in which the surviving spouse died,[129] or

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126 Prop. Reg. § 1.6662-8(b); see also IRC § 6662(b)(8)..

127 *See* discussion at Sections II.B.3. and IV.B. *infra*.

128 Frank J. O'Connell and Sally E. Day, "Marital Trusts and the Sec. 754 Election," The Tax Adviser Magazine, Tax Clinic, 9-06 T.T.A. 514 (Sept. 2006).

129 Reg. § 1.754-1(b).

12 months later under the automatic relief provision of Reg. § 301.9901-2.[130] Failing that, the partnership may request permission to make a late election pursuant to Reg. § 301.9901-3 if the partnership has acted reasonably and not on the basis of hindsight. By the same token, when a partnership interest is included in the decedent's estate under § 2044, it would also be subject to the mandatory basis adjustment rules if it has a substantial built-in loss under § 743(b).[131]

N. Partnerships Included under § 2036

Partnership interests included in a decedent's estate under § 2036 will achieve the benefits of a § 754 election whether the partnership makes an election for not. In Ltr. Rul. 200626003 the IRS denied an LLC permission to make a late § 754 after a partner died because the partnership did not act reasonably and in good faith and was acting in hindsight.[132] The partnership initially declined to make the election because the partners decided that the benefit "did not outweigh the complexity of creating multiple bases." But after the IRS audited the estate tax return and included the full value of the real estate in the father's gross estate under § 2036(a)(1), the partners changed their mind and asked for permission to make a late § 754 election.

Even though the IRS denied the late § 754 election, it allowed a stepped up basis for the partnership's asset under § 1014(b)(9) on the basis that it was property "acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment).." Thus, the Service allowed the LLC to adjust the basis of the real estate, without a § 754 election.

The Tax Court also reached this same conclusion in *Jorgensen v. Commissioner* for partnership assets included in the decedent's estate under § 2036.[133] This is particularly significant because the assets in the Jorgensen's estate included partnership interests owned by other family members who had received their interests by gift many years before Jorgensen's death. Nonetheless, the Tax Court invoked the doctrine of equitable recoupment under § 6214(b) and allowed the other family members to amend their tax returns, which were otherwise barred by the statute of limitations, to reduce gains previously reported .

IV. TAXATION OF DISTRIBUTIONS

A. General Rules

The general rule is that partnership distributions are not taxable to the partner or the partnership, unless any money distributed exceeds the partner's basis in his partnership interest.[134] However, exceptions nearly swallow up this rule. For example, the IRS can treat distributions of property as money based on substance over form if the distribution has no business purpose.[135] Similarly, marketable securities can be treated like money under § 731(c).

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130 Reg. § 301.9901-2(a)(2)(vi).

131 *See* discussion at Section III.F. of this outline.

132 Ltr. Rul. 200626003 (July 28, 2006).

133 Jorgensen v. Comm'r, T.C. Memo 2009-66 (Mar. 26, 2009), *aff'd* 107 AFTR 2d 2011-2069 (9th Cir 2011).

134 IRC §§ 731(a), (b).

135 CCA 200650014 (Sept. 7, 2006) (where the property was selected by the distributee, acquired by the partnership immediately before the distribution solely for the purpose of distribution, and was unrelated to the partnership's business.); see also Countrywide Limited Partnership et al v. Comm'r, T.C. Memo 2008-3 (Jan. 2, 2008) (The IRS

So can the transfer of partnership property to a partner in satisfaction of a guaranteed payment under § 707(c). It will constitute a taxable sale or exchange between the partner and the partnership.[136] Distributions of ordinary income property under § 751 can be taxable. Distributions can also be treated as "disguised sales" under § 707(a). And finally, distributions of property within seven years of a contribution of property can be treated as a sale between partners under §§ 704(c)(1)(B) and 737. Therefore, it is more correct to say that taxable distributions are the norm and tax-free distributions the exception.

1. When Distributions are Deemed to Occur

Distributions are generally aggregated and treated as all occurring on the last day of the partnership's tax year.[137] However, certain distributions that are treated as "disguised sales" under § 707(a) are deemed to occur on the actual day of the transaction.[138] And distributions of pre-contribution gain or loss property within seven years of a contribution of property to the partnership are deemed to occur on the actual date of the transaction.[139]

2. Basis of Property Distributed

In a nonliquidating distribution of property, the partner takes a carryover basis equal to the basis of the property in the hands of the partnership, limited to the partner's basis in his partnership interest.[140] If the basis of the distributed property exceeds the partner's basis in his partnership interest, the excess "disappears," unless the partnership has a § 754 election in effect.[141] With a § 754 election, the partnership steps up the basis of its remaining property.

The rules on liquidating distributions are different. The partner's basis in his partnership interest becomes the new basis for the property received in liquidation of his interest.[142] As in a nonliquidating distribution, if the basis of property distributed exceeds the partner's basis in his partnership interest, the excess "disappears," unless the partnership has a § 754 election in effect.[143] If a § 754 election is in place the excess increases the basis of the partnership's remaining property. However, if the basis of property distributed in liquidation is less than the partner's basis in his partnership interest, the partner steps up the basis in the property distributed. The partnership must also reduce the basis of its remaining property, but only if the partnership has a § 754 election in effect or the adjustment is more than $250,000.[144]

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alleged that note distributed in liquidation of a partner's interest had no legitimate business purpose and should therefore be treated as cash distributions resulting in a gain to the partners. However, the Tax Court held in favor of the taxpayer finding a legitimate business purpose because the economic interest of the partners had changed.)

[136] Rev. Rul. 2007-40, 2007-25 I.R.B. 1426 (June 1, 2007).

[137] Reg. § 1.731-1(a)(1)(ii).

[138] Reg. § 1.707-3(a)(2).

[139] Reg. §§ 1.704-4(b), 1.737-1(d).

[140] Reg. § 1.732-1(a).

[141] *See* discussion at Section III.H. for adjustments to the basis of the partnership's remaining property where a § 754 election is in effect.

[142] Reg. § 1.732-1(b).

[143] *See* discussion at Section III.H. for adjustments to the basis of the partnership's remaining property where a § 754 election is in effect.

[144] *See* discussion at Section IV.B.

If multiple properties are distributed, the partner's basis is first reduced by any cash received. Then it is reduced by the basis of any inventory and unrealized receivables (i.e. ordinary income property). The remaining basis is allocated to property first in an amount equal to its unrealized appreciation and the remainder is allocated on relative fair market values.[145]

3. Holding Period

Where the partner receives a carryover basis in property distributed by the partnership, he also receives a carryover holding period in the asset.[146] Therefore, distributions of capital assets held by the partnership for more than a year will allow a partner to achieve long-term capital gain on a sale of the asset even if he has held his partnership interest less than a year. Likewise, if the partnership distributes property owned for less than a year to a partner who acquired his interest from a decedent (and thus has a long-term holding period in his partnership interest) the partner will have a short-term gain or loss upon immediate sale of the property. Thus, there is generally no interruption in the holding period of partnership assets, even where the partnership makes a § 754 election to adjust the inside basis of its assets.[147] There is simply no authority to tack the holding period of the partnership interest to the basis of the partnership assets.

B. Distributions that Require Mandatory Basis Adjustments

The American Jobs Creation Act added three new mandatory basis adjustment rules to prevent partners and partnerships from duplicating losses.[148] Although these rules were aimed at corporate tax shelters, many family partnerships are impacted by them. But Congress failed to offer any special exception for family partnerships. These new mandatory basis adjustment rules do not themselves trigger gain or loss recognition. They merely require the partnership to adjust the basis of its assets when it makes certain types of distributions. Note that basis adjustments only affect the timing of a partner's income or loss and not the amount. Treasury has not yet written regulations to resolve the many questions surrounding these new mandatory basis adjustments. However, the regulations are still on IRS and Treasury's Priority Guidance Plan.[149]

1. Mechanics

Two kinds of distributions made after October 22, 2004 require the partnership to adjust the basis of property on its books. The first is when a partner receives a liquidating distribution of cash that is less than the basis in his partnership interest by more than $250,000.[150] The second is when a partner receives a liquidating distribution of property, the basis of which is less than his basis in his partnership interest by more than $250,000.[151] In other words, after October 22, 2004, a partnership that cashes out a partner at a loss of more than $250,000 or redeems a partner

[145] Reg. § 1.732-1(c).
[146] IRC § 735(b).
[147] Rev. Rul. 68-79, 1968-1 C.B. 310 (the holding period of a partnership interest does not affect the holding period of the partnership assets.)
[148] IRC §§ 704(c)(1)(C), 734(a) and 743(a).
[149] Department of the Treasury 2015-2016 Priority Guidance Plan, Third Quarter update, April 29, 2016, *available at* http://www.irs.gov.
[150] IRC §§ 734(d), 734(b)(2).
[151] *Id.*

with property the basis of which is less than the partner's basis in his partnership interest by more than $250,000 must reduce the basis of assets remaining on the partnership's books.

EXAMPLE

> Dad and Mom contribute $10,000,000 to a family partnership and gift Son 50 percent of the partnership over time. In the meantime, the partnership purchases Stock A for $3,000,000 and Stock B for $7,000,000. The stocks decline in value to $1,000,000 each. Now Son wants to cash out his 50 percent interest worth $1,000,000. The partnership borrows $1,000,000 to cash him out. Son reports a loss of $4,000,000 [$5,000,000 basis - $1,000,000]. Because this loss exceeds $250,000, the partnership must reduce the basis of its assets by the $4,000,000 loss. [152]

EXAMPLE

> Same facts as above, except that the partnership distributes Stock A worth $1,000,000 to Son in liquidation. Son increases the basis in Stock A from $3,000,000 in the hands of the partnership to his $5,000,000 basis in the partnership interest. This is a positive basis adjustment of more than $250,000 and therefore, the partnership must reduce the basis of Stock B by $2,000,000.[153]

The downward basis adjustment of $2,000,000 to Stock B has a detrimental effect on Mom and Dad because when the partnership sells Stock B for $1,000,000, they are only entitled to a $4,000,000 loss [$1,000,000 – ($7,000,000 - $2,000,000)] instead of a $6,000,000 loss [$1,000,000 - $7,000,000] as under the old rules where the partnership did not have a § 754 election in effect. In essence, the new rules mandate that the basis of partnership property be reduced (but not increased) as if the partnership had a § 754 election in effect. Rather than being elective as under prior law, negative basis adjustments are now mandatory.

Positive adjustments to the partnership's property in the year it distributes high basis property to a low basis partner, however, are not mandatory. But they are highly desirable and can only be made if the partnership makes a § 754 election. Therefore, the partnership should consider making the § 754 election anytime it distributes high basis property to a low basis partner, especially when liquidating a deceased partner's interest.

2. Effect of a Section 754 Election

Section 734(b) is especially a trap when a partner receives a stepped up basis for his partnership interest because of a death or a purchase and the partnership subsequently distributes cash or low basis property to that partner. The distribution of low basis property to the high outside basis partner requires the partnership to reduce the basis of its other assets.

EXAMPLE

> Assume the same facts as above except that Son stays in the partnership and Dad dies when the stocks have increased to $8,000,000 each. The partnership redeems the

[152] IRC §§ 734(b)(2)(A), (d)(1); see also H.R. Rep. No. 108-548, pt.1 (June 16, 2004).

[153] IRC §§ 734(b)(2)(B),(d)(1); Example adapted from Notice 2005-32, 2005-16 I.R.B. 895 (Apr. 1, 2005).

> estate's 25 percent interest by distributing half of Stock A worth $4,000,000 with a basis of $1,500,000. Dad had a basis in his partnership interest of $2,500,000, but under § 1014 his estate's new basis is his date of death value of $4,000,000. Under § 732(b), the estate increases the basis of Stock A from $1,500,000 to $4,000,000. However, this $2,500,000 positive adjustment requires the partnership to reduce the basis of Stock B by $2,500,000 under § 734(b).

In essence, the step-up under § 1014 gets incorporated into the new mandatory basis reduction rules. On the other hand, if the partnership had made a § 754 election in the above example, the estate would have been entitled to step up its share of the inside basis of partnership assets from $2,500,000 to $4,000,000. This new inside basis of $1,500,000 would have been added to the basis of half of Stock A received in the liquidation, giving it a new basis of $3,000,000 ($1,500,000 + $1,500,000). Now the estate only has a positive adjustment of $1,000,000 to increase the basis of Stock A to equal its outside basis of $4,000,000 under § 732(b). Thus the partnership only needs to reduce the basis of Stock B by $1,000,000 under the mandatory basis adjustment rules of § 734(b).

It may be tempting for the partnership to make a § 754 election as soon as it discovers the problem. Presumably there will still be time to make it for the distribution year. This not only avoids the extra basis reduction in the current year, but it allows the partnership to increase the basis of its property when it distributes high basis property to a low basis partner later on. However, it is not automatic that the partnership should make an election to cure this problem. The election will impact all future deaths, transfers, and distributions. The short-term benefit may not be worth the long-term cost. There are circumstances in which the election should not be made.[154] Moreover, these basis adjustments are merely timing differences. Regardless of their size or frequency, a partner will never report more income than he receives during the life of the partnership. Any basis remaining on liquidation of his interest will eventually be used.

C. Distributions Within Seven Years of Contribution

During the 1980s enterprising partners began to stretch the limits of the general rule that partnership distributions are tax-free. They simultaneously contributed appreciated property, while they or others withdrew property with no tax consequence. In effect, they achieved a tax-free exchange through the partnership without following the § 1031 rules. Such transactions are known as "mixing bowl" transactions.[155] This term is now enshrined in the IRS's audit training manual and defined as: "Transactions in which partners arrange to pool their assets in a partnership, and then make related allocations or distributions in order to shift the benefits and burdens of ownership."[156] To correct these perceived abuses, Congress created the anti-mixing bowl statutes contained in §§ 704(c)(1)(B), 737, and 731(c). Unfortunately, these rules also snare innocent family partnerships that were never intended to be the target.

[154] *See* Exhibit B, Section 754 Decision Tree *infra.*

[155] 90 TNT 97-46.

[156] Glossary, IRS Market Segment Specialization Program Guideline, 2002 WL 32076538.

1. Distributions of Contributed Property - § 704(c)(1)(B)

If a partnership distributes property with respect to which a contributing partner has built-in gain or loss, to another partner within seven years of the contribution, the contributing partner must recognize gain or loss.[157] Thus, § 704(c)(1)(B) requires the partnership to track all pre-contribution gains and losses, on a property by property basis, for seven years from its contribution date to its date of disposition. This is an ongoing process as each built-in gain or loss property is contributed or distributed. It is usually a complete surprise to all the partners that § 704(c)(1)(B) taxes the contributing partner instead of the partner who receives the distribution.

a. Computing Gain or Loss

If a contributing partner's built-in gain or loss property is distributed to another partner within seven years of its contribution, the contributing partner recognizes gain or loss as if the property were sold at its market value on the distribution date. However, the gain or loss is limited to the contributing partner's pre-contribution gain or loss on the property.[158] The partnership adjusts the basis of the property by the contributing partner's recognized gain or loss.[159] And the contributing partner adjusts his basis in the partnership interest accordingly.[160]

EXAMPLE

> On July 1, 2010 Partner A contributed Property X with a basis of $10,000 and a market value of $20,000 to AB Partnership for a 50 percent interest. On July 1, 2012 AB Partnership distributes Property X to B when its value is $40,000. A recognizes pre-contribution gain as if the property were sold for $40,000 on July 1, 2012. The hypothetical gain of $30,000 ($40,000 FMV - $10,000 basis) is allocated $20,000 to A ($10,000 pre-contribution gain plus one-half the post-contribution gain of $20,000). However, the gain recognized under § 704(c)(1)(B) is limited to A's pre-contribution gain of $10,000. If, instead, Property X had declined in value to $15,000 on the distribution date, A would only recognize $5,000 of pre-contribution gain ($10,000 pre-contribution gain limited to the actual gain of $5,000).

The *amount* of the gain or loss reported by the contributing partner under § 704(c)(1)(B)(i) is determined as if the property were sold at its market value on the distribution date to the distributee partner.[161] The *character* of the gain or loss is also determined as if the property had been sold to the distribute partner.[162] This raises the question whether a § 704(c) loss would be disallowed if the distribute partner owns more than 50 percent of the partnership under § 707(b)(1)(A). The Service would probably maintain that built-in losses under § 704(c)(1)(B) losses are disallowed to the contributing partner where the distributee partner owns more than a 50 interest.[163] However, there are no cases, regulations, or rulings on this point.

157 IRC § 704(c)(1)(B).
158 IRC § 704(c)(1)(B)(i).
159 Reg. § 1.704-4(e)(2).
160 IRC § 704(c)(1)(B)(iii); Reg. § 1.704-4(e)(1).
161 Reg. § 1.704-4(a)(1).
162 IRC § 704(c)(1)(B)(ii)
163 Preamble to Reg. § 1.704-4, T.D. 8642 (Dec. 22, 1995).

b. Character of Gain or Loss

The gain or loss recognized by the contributing partner under § 704(c)(1)(B) has the same character as if the partnership had sold the property to the distributee.[164] For example, assume A contributes land to the AB Partnership, which is a capital asset in the hands of the partnership. But if AB distributes the real estate to Partner B, who uses the property in his trade or business and holds more than a 50 percent interest in the partnership, the gain would be ordinary income under § 707(b)(2). Therefore, the character of the gain to Partner A would be ordinary income.[165]

c. Step-in-the-Shoes Rule

Section 704(c)(1)(B) applies to a transferee partner just as it would to the transferor partner with a § 704(c) gain for property contributed on or before October 22, 2004.[166] So, if a partner that contributes § 704(c) property transfers (sells, exchanges, or gifts) his partnership interest and the § 704(c) property is thereafter distributed to a partner other than the transferee partner within seven years of its contribution, the transferee partner is taxed as the original contributor of the § 704(c) property. In other words, he "steps into the shoes" of the transferor for purposes of § 704(c). The step-in-the-shoes rule does not apply, however, to property with a built-in loss contributed to the partnership after October 22, 2004.[167]

2. Distributions of Other Property to a Contributing Partner - § 737

Section 737(a) was enacted to assure that partners did not avoid recognizing § 704(c) gains by cashing in their partnership interest with other property while the partnership continued to own the § 704(c) property.[168] Therefore § 737 taxes a partner that receives a distribution of partnership property within seven years (five, for property contributed on or before June 8, 1997) of when the partner contributed any other appreciated property to the partnership.

Section 737 taxes the partner who receives a distribution, whereas § 704(c)(1)(B) taxes the partner who contributes the § 704(c) property. Another key difference between § 704(c)(1)(B) and 737 is that gain under § 737 is limited to the excess of the property's market value over the partner's basis in his partnership interest. Contrast § 704(c)(1)(B), which determines the contributing partner's gain or loss as if the property were sold on the distribution date, ignoring his basis in the partnership interest. Finally, unlike § 704(c)(1)(B), § 737 never results in a loss.

a. Computing the Gain

Section 737 functions differently than § 704(c)(1)(B). Under § 737, the distributee recognizes gain (but not loss) equal to the lesser of (1) the excess of the market value of property (other than money) received over the adjusted basis of the partner's interest in the partnership immediately before the distribution; or (2) the partner's "net pre-contribution gain." Net pre-contribution gain means the gain that would be allocated to the distributee under § 704(c)(1)(B)

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[164] IRC § 704(c)(1)(B)(ii).

[165] Reg. § 1.704-4(b)(2)(iii).

[166] Reg. § 1.704-4(d)(2); *but see* IRC § 704(c)(l)(C) added by P.L. l08-457, § 833 (October 22, 2004).

[167] IRC § 704(c)(l)(C) added by P.L. l08-457, § 833 (October 22, 2004); *see* discussion at Section IV.C.3. *infra.*

[168] H. Rep't. No. 102-1018, 102nd Cong, 2d Sess., 1992 U.S.C.C.&A.N. 2472, 2519-2520 (10/5/92).

if all the property that had been contributed to the partnership immediately before the distribution were distributed to another partner.[169] Distributions of a partner's own previously contributed property are not taken into account under § 737.[170] Note also that unlike § 704(c)(1)(B), the distributee's basis in his partnership interest limits the amount of gain recognized under § 737.

EXAMPLE

Partner A contributes Property X with a basis of $10,000 and a market value of $20,000 to AB Partnership for a 50 percent interest. Partner B contributes Property Y with a basis of $20,000 and a market value of $20,000. Within seven years of A's contribution, Property Y is distributed to A when its value is $40,000. A recognizes pre-contribution gain of $10,000, which is the lesser of his § 704(c) gain of $10,000 or the excess of the property's value ($40,000) over A's basis in his partnership interest ($10,000). If, instead, Property X was worth $15,000 on the distribution date, A would only recognize $5,000 of pre-contribution gain, the lesser of his $10,000 § 704(c) gain, or the excess of the property's $15,000 market value over A's $10,000 basis in his partnership interest.

Any gain recognized under § 737 is added to the partner's basis in his partnership interest immediately before the distribution of the property to him.[171] The basis of the distributee's § 704(c) property remaining in the partnership is also increased.[172] But the increase only applies to the distributee partner's built-in gain (not loss) property of the same character if sold by the partnership as the character of the gain recognized by him in the § 737 distribution. The property distributed to him takes a carryover basis determined under the normal basis rules in § 732.

Section 737 does not apply to distributions of property that a partner previously contributed to the partnership.[173] Thus, in the above example, if Property X (instead of Y) had been distributed to Partner A, § 737 would not have applied. Similarly, if only half of Property X (worth $20,000) and half of Property Y (worth $10,000) had been distributed, § 737 would ignore the half of Property X distributed and apply only to distribution of Property Y. We would treat the portion of Property X as if it had been distributed to Partner A in a separate and independent distribution prior to the distribution of Property Y.[174] Thus, the fair market value, basis, and pre-contribution gain attributable to half of Property X are simply omitted from the § 737 calculation and gain on the distribution is only $5,000 as follows:

	Distribution of ½ X and Y to Ptr. A	Less prev. contributed Property X	Rest subject to §737
FMV of distribution	$30,000	20,000	10,000
Basis in pship interest	$10,000	5,000	5,000
Pre-contribution gain (net)	$10,000	5,000	5,000

169 Reg. § 1.737-1(c)(1).
170 IRC § 737(d)(1).
171 IRC § 737(c)(1).
172 IRC § 731(c)(2).
173 IRC § 737(d)(1).
174 Reg. § 1.737-3(b)(2).

b. Character of Gain

The character of gain recognized by the distribute partner under § 737 is determined at the partnership level as if the partnership sold all the partner's § 704(c) property to an unrelated third party at the time of the distribution.[175] Most property contributed to a family partnership will be long-term capital gain character. However, if there are other character types, they are netted and separated into the same categories as would be required to be separately stated on the partner's schedule K-1. These include, for example, long-term capital gains and losses, short-term capital gains and losses, § 1231 gains and losses, and foreign source items.[176] In that case, the distributee partner recognizes gain in proportion to each character category.

c. Step-in-the-Shoes Rule

Like § 704(c)(1)(B), a transferee (donee) partner steps into the shoes of the transferor partner under § 737. Thus, the transferee is treated as the contributing partner both with respect to the transferor's § 704(c) gain or loss and also for purposes of whether the transferee receives his own property back on a distribution. However, some commentators believe that Reg. § 1.737-1(c)(2)(iii) may be interpreted as allowing a transferee partner to step into Shoe #1 with respect to inheriting the transferor's § 704(c) gain, but not Shoe #2 for determining whether he is the contributing partner of property distributed to him.[177] While Reg. § 1.737-1(c)(2)(iii) states clearly that a transferee succeeds to the transferor's § 704(c) account, it merely refers to Reg. §§ 1.704-3(a)(7) and 1.704-4(d)(2) "for similar provisions in the context of §§ 704(c)(1)(A) and 704(c)(1)(B)" for the treatment of transferee partners. This casual reference makes some people unsure about whether the transferee is treated as the contributing partner under § 737.

However, it makes little sense to treat a transferee partner as a contributing partner under § 737 to determine the extent of his potential gain under § 704(c)(1)(B), but not treat him as a contributing partner for purposes of determining whether he gets his own property back. The regulations under both sections were designed to harmonize the two statutes. They were written at the same time, by the same people, as part of the same regulation project, and are liberally laced with cross-references to each other.[178]

There is no reason to believe that Congress or the IRS intended to tax a transferee partner more harshly than the contributing partner. Despite the inartful drafting, leading partnership treatises assume that the IRS meant to treat the transferee partner as the contributing partner both for determining the § 704(c) net pre-contribution gain and for purposes of whether he receives a distribution of his own property back – i.e. the transferee steps in both the transferor's shoes.[179] This author also assumes that the two statutes work in tandem as they were designed to, and that

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[175] Reg. § 1.737-1(d).

[176] Reg. § 1.702-1(a).

[177] "Unwinding the Family Limited Partnership: Income Tax Impact of Scratching the Seven Year Itch," J. TAX'N, (March 2002); *see also* Sheldon I. Banoff & Richard M. Lipton, eds., "When is a Transferee Partner a Contributing Partner?" J. TAX'N (May 2003).

[178] T.D. 8642, 60 Fed. Reg. 66,727 (Dec. 26, 1995).

[179] Willis, Pennell, & Postlewaite, PARTNERSHIP TAXATION, Sixth Edition (Warren Gorham & Lamont, 2004) ¶13.02[1][a][v] at 13-21; and McKee, Nelson, & Whitmire, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, Fourth Edition (Warren, Gorham & Lamont, 2007), ¶19.08[2][e], fn. 167.

a transferee partner completely steps into the transferor partner's shoes under both §§ 704(c)(1)(B) and 737.

D. Distributions of Marketable Securities - § 731(c)

Because marketable securities are the virtual equivalent of cash, § 731(c) provides that a distribution of marketable securities will be treated as a distribution of money, unless an exception applies. To the extent marketable securities are treated as money, a partner may recognize gain under § 731(a) when he receives money in excess of his basis in the partnership interest. In addition, to the extent marketable securities are treated like money, it reduces the amount treated like property for purposes of § 737 (gain on distributions of property within 7 years of a contribution of appreciated property).[180] Any gain recognized on the distribution of marketable securities increases the basis of the distributed securities.[181]

1. Marketable Securities Defined

Marketable securities under § 731(c)(2) means financial instruments and foreign currencies that are actively traded. It includes stocks and other cash-like instruments including common trust funds, regulated investment companies, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, derivatives, foreign currencies, precious metals, and interests in entities containing such property.[182] Although the definition seems broad, it does not cover every type of security. For example, a flexible premium variable life insurance policy is not a security for purposes of § 731(c).[183] In addition, privately issued notes are not marketable securities.[184] Nor is § 731(c) as broad as the list of securities in § 351(e), which determines whether property contributed to an investment company is taxable under § 721(b). The primary difference is that § 731(c) focuses on cash equivalents, whereas § 351(e) targets all stocks and securities, including stock in closely held businesses and employee stock options.

2. Reduction in the Amount Treated Like Money

If the value of marketable securities distributed to a partner exceeds his basis in his partnership interest, the amount treated like money may be reduced by his share of unrealized gain in those securities.[185] To determine his share of unrealized gain, all marketable securities held by the partnership are aggregated.[186] Regardless of which marketable securities the partnership distributes, the distributee partner's share of the gain is measured before and after the distribution. The difference reduces the amount of the distribution treated like money. Thus, the partner's share of unrealized gain on marketable securities acts is the most that can reduce the portion treated like money on a distribution. The regulations provide a good example.[187]

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[180] *See* discussion at IV.C.2 of this outline.
[181] Reg. § 1.731-2(f)(1).
[182] IRC § 731(c)(2).
[183] Ltr. Rul. 200651023 (Sept. 21, 2006).
[184] Countryside Limited Partnership v. Comm'r, T.C. Memo 2008-3 (Jan. 2, 2008).
[185] IRC § 731(c)(3)(B); Reg. § 1.732-2(b)(2).
[186] IRC § 731(c)(3)(B); Reg. § 1.731-2(b)(1).
[187] Reg. § 1.731-2(j).

EXAMPLE

A and B are equal partners in AB partnership, which holds securities X, Y, and Z worth $100 each and with a basis of $70, 80, and $110 respectively. AB distributes X to A in a current distribution. His share of the gain before the distribution is $20 and his share after the distribution is $5. Thus, A may reduce the portion of Security X that is treated like cash by the $15 difference. So, only $85 of Security X is treated like cash and the balance is treated like property.

WITH X:	Value	Basis	Gain or Loss	A's Share
X	100	70	30	
Y	100	80	20	
Z	100	110	-10	
	300	260	40	$20
WITHOUT X:				
Y	100	80	20	
Z	100	110	-10	
	200	190	10	5
Difference				$15

All we have done up to this point is figure the amount of the distribution that is treated like cash to A. To the extent that the deemed cash portion does not exceed the basis in his partnership interest, A will not report any gain on the distribution and his basis in the partnership interest is not reduced. He simply takes a carryover basis in the distributed securities.

The partnership can select specific securities in such a combination as to minimize or maximize the partner's gain on distribution. If the partner's outside basis is large enough to absorb a cash distribution without recognizing gain and if a property distribution would have negative consequences for him under § 737, then it may be better to maximize the portion of the distribution treated like cash. In the above example, if the partnership had distributed Y instead of X, the amount treated like cash would have been $90 instead of $85.[188] And if Z had been distributed, the entire $100 would be treated like cash because there is no gain in Security Z.

3. Impact of Valuation Discounts

Valuation discounts on a partnership interest can significantly increase the likelihood that distributions of marketable securities to an estate or successor partner will be taxable. The value of distributed securities is treated like money and to the extent it exceeds the partner's outside basis in the partnership, the partner recognizes gain on the distribution.[189] Although § 731(c)(3)(B) reduces the amount treated like money by the partner's share of gain on the securities, this reduction may not be sufficient to completely avoid gain recognition.

EXAMPLE

[188] $100 value of Y less A's $10 share of gain in Y.
[189] IRC § 731(a), (c).

> Mabel died with an 80 percent interest in XYZ partnership, which owned $2,000,000 of bonds with a basis of $1,500,000. An appraiser valued the partnership at $1,300,000 using a 35% discount. Thus, the estate's outside basis of the partnership interest is $1,040,000. The partnership redeemed Mabel's estate with $1,600,000 of bonds. Ordinarily the bonds would be treated like cash, resulting in a $560,000 gain to Mabel's estate. [$1,600,000-$1,040,000] But the amount treated like cash is reduced by the estate's share of gain in the bonds, or $400,000. Thus the amount treated like cash is only $1,200,000, resulting in a gain of only $160,000.[190]

	Total	**Mabel's 80%**
FMV of Securities	$ 2,000,000	$ 1,600,000
Tax Basis	1,500,000	1,200,000
Unrecognized Gain	500,000	400,000
FMV/Outside Basis under § 1014 (with a 35% discount)	$ 1,300,000	$ 1,040,000

Note that § 731(c) merely causes the estate or other successor partner to recognize gain it would eventually recognize when it sells the securities. This may not be a problem if the estate plans to sell the securities shortly after receipt. But it can be avoided.

Assume the partnership in the above example makes a § 754 election. The estate's basis in the bonds is now $1,040,000, exactly the same as its outside basis. Therefore, a distribution of the bonds will not cause the estate or successor partner to recognize gain under § 731(a).[191] Note that making a § 754 election in this case runs counter to intuition because it reduces the estate's inside basis of the assets. However, under these circumstances it avoids a premature recognition of gain on a distribution of the securities.

Alternatively, if the partnership did not make a § 754 election, the estate or successor partner can make a § 732(d) election instead. This has the same effect as if the partnership had made a § 754 election, but without the consequences of a § 754 election on the other partners.[192] The basis adjustments under § 732(d) can be made to assets on hand at the date of death or to "like-kind" property if those assets no longer exist.[193] However, a § 732(d) election can only be made for property distributions made within two years of the decedent's death.

4. Statutory Exceptions

If the partner cannot avoid gain under the rule allowing him to reduce the amount treated like money by his share of the gain in the securities being distributed, he may qualify for one or

[190] IRC § 731(c)(4)(A); The estate is also entitled to increase the basis of the distributed securities by $160,000.
[191] Reg. § 1.731-2(b)(3).
[192] *See* discussion at III.H. for impact of a § 754 election on the other partners.
[193] Reg. § 1.743-1(g)(2)(ii).

more of three outright exceptions to the rule treating marketable securities like money.[194]

● First, marketable securities are not treated as money when distributed to the partner who contributed the security. This is because Congress did not intend to tax a partner who merely got his own property back. Instead the statute seeks to tax a partner who exchanges other property for an interest in marketable securities which Congress considered equivalent to a sale.

Under § 731(c) the transferee of a partnership interest is not treated as the contributor of the transferor's property. Thus, if Partner A transfers securities to a partnership and transfers his partnership interest to Partner B, Partner B is not treated as the contributing partner when he takes a distribution of those securities. Thus, Partner B treats the securities as money. This is in sharp contrast to the rules under §§ 704(c)(1)(B) and 737, which treat a transferee partner as the contributor of the transferor partner's property. However, the legislative history and purposes of § 731(c) differ from those of §§ 704(c)(1)(B) and 737. Section 731 treats marketable securities as cash because they are cash equivalents, not because partners are using them to avoid § 704(c) gain recognition, which is the focus of §§ 704(c)(1)(B) and 737. Thus, it appears that transferee partners, including estates, are not treated as contributing partners under § 731 with respect to distributions of marketable securities.

● Second, marketable securities are not treated like money if the property was not a marketable security when acquired by the partnership.

● Third, marketable securities are not treated like money when distributed by an "investment partnership" to an "eligible partner."[195] An investment partnership is one that has never been engaged in a trade or business (other than investing) and substantially all of the assets of which (by value) have always consisted of investment type assets listed under § 731(c)(3)(C)(i). Note that this list includes nonmarketable securities such as stock in a corporation. "Substantially all" means consisting of 90 percent or more marketable securities or money.[196] An eligible partner is one who has never contributed any non-investment type assets to the partnership

Partnerships that relied on the "less than 80% stocks and securities" test to avoid gain recognition on formation under §§ 721(b) and 351(e) will not meet this 90 percent test for an investment company under § 731(c). Thus, marketable securities will be treated like money distributions. However, it is not uncommon for a family partnership's assets to have always consisted of 90 percent investment securities. It may have relied on the diversified portfolio exception to the investment company rules to avoid gain.[197] Or there may have been no built-in gain on the assets contributed to form the partnership. In either case, if a partnership meets the "always more than 90%" test, distributions of marketable securities will not be treated like cash.

E. Ordering Rules When Multiple Statutes Are Involved

When a family partnership distributes cash or property, in complete termination or otherwise, it can easily invoke all three mixing bowl statutes at the same time. For example,

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194 IRC § 731(c)(3)(A).

195 Reg. § 1.731-2(d).

196 Reg. § 1.731-2(c)(3).

197 *Id.*; *see also* Reg. § 35l-l(c)(6); IRC § 368(a)(2)(F)(ii).

distributing a marketable security that has pre-contribution gain or loss within seven years to a partner who has a pre-contribution gain or loss account under § 704(c) created within the last seven years will invoke all three statutes and likely be taxable to one of the partners. Section 704(c)(1)(B) taxes the contributing partner as if the property were sold at market value on the distribution date. Section 731(c) taxes the distributee partner to the extent that the money portion exceeds the partner's basis in his partnership interest. And finally, § 737 taxes the distributee partner to the extent that the fair market value of the property portion of the security exceeds the basis in his partnership interest.

When all three statutes are involved, the regulations require an ordering rule – first § 704(c)(1)(B), then § 731(c), and § 737.[198] The regulations do not, however, provide an example of all three mixing bowl statutes working together. In addition, if the partner also has a § 743(b) basis adjustment because the partnership made a § 754 election[199] or was subject to the mandatory basis adjustment rules,[200] this basis adjustment needs to be taken into account under all of the mixing bowl statutes.

But these problems can be avoided with a little forethought. Absent other non-tax considerations, partnerships attempting to minimize or avoid adverse tax consequences on termination or distribution of partnership assets should adhere to the following:

- Avoid terminating the partnership until seven years after the last contribution of built-in gain property
- Avoid distributing cash in excess of a partner's basis.
- Distribute property that the partnership has purchased.
- Distribute property in proportion to each partner's interest in the partnership if the distribution occurs within seven years of a contribution of built-in gain or loss property by one of the distributees.
- Avoid distributing previously contributed built-in gain or loss property to partners other than the partner (or transferee partner) who contributed the property within seven years of the contribution.
- Avoid distributing property to a partner who has previously contributed other built-in gain property or is a transferee of one who has contributed other built-in gain property.
- Distribute marketable securities pro rata based on their value, regardless of their different cost bases.

V. IMPACT OF THE PROPOSED SECTION 2704 REGULATIONS

As if the income tax traps were not enough to deal with on redemption or liquidation of a family partnership, the IRS has now published proposed regulations under Section 2704 that treat a redemption of a partner's interest as a gift to the extent the partner receives less than an amount

[198] Reg. § 1.731-2(g)(1); *see* Exhibit A, Mixing Bowl Flowchart for Partnership Property Distributions *infra*.
[199] *See* discussion at Section III.B. *infra*.
[200] *See* discussion at Section III.F. *infra*.

determined under a hypothetical valuation on termination of his or her interest.[201] These new regulations will generally be effective for transfers occurring after the regulations are published in final.[202]

The proposed regulations affect both Section 2704(a) and 2704(b). However, the most significant and controversial portion of them are the changes proposed to Section 2704(b) involving the new "disregarded restrictions," which appraisers must ignore in valuing an interest transferred to or for the benefit of a family member.

A. The Three-Year Rule Under Section 2704(a)

If an individual transfers an interest in a family-controlled entity within three years of his death that results in the loss of the transferor's ability to force the liquidation of the entity (such as the transfer of a minority interest by a 100% shareholder), the value of the lapsed voting or liquidation right will be included in the transferor's taxable estate once the regulations are finalized. The value of the lapsed right will not, however, qualify for the marital or charitable deduction because it cannot be transferred, having expired.

Before the proposed regulations are finalized, if a donor owns the right to liquidate and gives enough shares to his children to divest himself of the right to liquidate, Section 2704(a) does not apply because the right to liquidate has not lapsed; it has simply been divided among the children. However, under the proposed regulations, if the donor dies within three years of divesting himself of the right to liquidate, the right to liquidate is deemed to have lapsed at his death, and his gross estate will include the value of the lapsed right. In addition, his gross estate will include the value of the decedent's remaining shares, but valued without considering the disregarded restrictions listed in Section 2704(b).

1.When the Three-Year Rule Applies

The three-year rule under Section 2704(a) applies *only* if a) an individual holds a sufficient interest to give the person the right to force the liquidation of the entity; b) that individual transfers enough of the interest so that he can no longer force the liquidation of the entity; and c) the family controlled the entity both before and after the transfer. In determining whether the individual has the right to force the liquidation of the entity, we consider only the *actual* rights the holder has under the governing documents and state law without ignoring the disregarded restrictions required to be ignored under the proposed regulations.

For example, if the individual holds 70% of the stock but the partnership agreement requires a unanimous vote of all the partners to liquidate, the individual does not hold a liquidation right and §2704(a) does not apply. The fact that a partnership agreement might require a higher percentage vote than state law would otherwise have provided is irrelevant. (Note that in Texas, and in many other states, a unanimous vote is required to liquidate a limited partnership and a majority vote is required to liquidate a limited liability company. T.B.O.C. § 101.552(a) (a majority vote of LLC members is required to voluntarily wind up the company unless otherwise provided by the company agreement); T.B.O.C. §11.058 (a unanimous vote of all the limited partners is required to voluntarily wind up the company, unless otherwise provided by the

[201] REG-163113-02; Prop. Regs. §§ 25.2701-2, 25.2704-1, 25.2704-2, and 25.2704-3.
[202] Prop. Reg. § 25.2704-4(b).

partnership agreement).

For purposes of determining whether the family controlled the entity before and after the transfer, we must not take into account any of the "disregarded restrictions" listed in the proposed regulations. Prop. Reg. §§ 25.2704-3; 25.2704-1(c)(2)(i). This makes it virtually certain that the family will meet the control requirement both before and after the transfer.

2. How to Measure the Gift Tax Value Under the Three-Year Rule

Under both the existing and the proposed regulations, the *amount* of the deemed transfer is calculated by comparing the value of all interests in the entity owned by the holder before the lapse (as if the right had not lapsed) with the value of those interests immediately after the lapse "determined as if all such interests were held by one individual." Reg. § 25.2704-1(d) (unchanged by the proposed regulations).

It is not entirely clear whether we value the lapsed right on the date of the actual transfer of the liquidation right or on the date of the transferor's death. However, it makes more sense to value the lapse on the date of the actual transfer since appraisals would theoretically have been obtained as of that date. Perhaps the final regulations will clarify this. But in any event, it is fairly rare that a donor will have a right to liquidate the entity unless he or she owns 100% of it because most family partnerships are drafted to require unanimous consent to liquidate.

B. The New Category of Disregarded Restrictions Under Section 2704(b)

The proposed regulations made more dramatic changes under Section 2704(b). They impose an entirely new category of "disregarded restrictions," which appraisers must ignore in determining the value of an interest in a family-controlled entity that is transferred to a family member if the family controls the entity before and after the transfer.[203]

1. What Transfers are Included?

Section 2704 does not define "transfer" for its purposes. However, it is clear from the examples in the proposed regulations, the gift tax regulations, and ample case law that a transfer for estate and gift tax purposes broadly includes any means by which property rights are passed on or conferred by gift, whether in trust or otherwise, direct or indirect, by bargain sale, forgiveness of indebtedness, assignment of benefits, or whatever "protean arrangements which the wit of man can devise that are not business transaction within the meaning of ordinary speech." [204] It is not necessary that the donor have a donative intent.[205] A gift occurs anytime property is transferred for less than an adequate and full consideration in money or money's worth. The amount by which the value of the property exceeded the value of the consideration is deemed a gift.

2. Restrictions That Must Be Disregarded

In general, a disregarded restriction means a limitation described in (i)-(iv) below on the ability to redeem or liquidate an interest in an entity if the restriction, in whole or in part, either

[203] Prop. Reg. § 25.2704-3(a).
[204] Reg. § 25.2522-1(a); Comm'r. v. Wemyss, 65 S. Ct. 652 (1945).
[205] Comm'r v. Wemyss, 65 S. Ct. 652 (1945).

lapses after the transfer or can be removed by the transferor or any member of the transferor's family, either alone or collectively.

These disregarded restrictions are:[206]

(i) The provision limits or permits the limitation of the ability of the holder of the interest to compel liquidation or redemption of the interest;

(ii) The provision limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than "minimum value." Minimum value is the holder's share of the value of the property held by the entity as determined under Section 2031 (estate tax) or 2512 (gift tax). If the entity owns an operating business, minimum value is determined under generally accepted valuation principles, taking into account the business's net worth, its dividend paying history, its earning power, and other relevant factors. In other words, it is *going concern* value rather than liquidation value.

(iii) The provision defers or permits the deferral of the payment of the full amount of the liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder's intent to have the interest liquidated or redeemed.

(iv) The provision authorizes or permits the payment of any portion of the liquidation or redemption proceeds in any manner other than cash or property. A promissory note issued by the entity, one of its partners, or anyone related to the entity or its partners, is not property for this purpose. However, the entity can issue a promissory note for the redemption proceeds attributable to the holder's share of an active business owned by the entity, if it is adequately secured, requires non-deferred periodic payments, bears a market interest rate, and has a fair market value equal to the liquidation proceeds.

The proposed regulation section 25.2704-3 clarifies that these provisions can be found in the entity's by-laws, partnership agreement, buy-sell agreement, assignment or deed of gift, or any other document, agreement, or arrangement.[207] The proposed regulations also require that restrictions imposed by local law be ignored, unless the provision is mandatory, which few are.[208] Most local laws are merely default rules that apply if the entity's governing instrument is silent. Such default rules are not mandatory for purposes of the proposed regulation.

[206] Prop. Reg. § 25.2704-3(b)(1).
[207] Prop. Reg. § 25.2704-3(b)(2).
[208] Prop. Reg. § 25.2704-3(b)(5)(iii).

3. Determining Whether the Family "Controls" the Entity

Section 2704(c)(2) provides that family members of an individual include a) the individual's spouse, b) any ancestor or lineal descendant of such individual or such individual's spouse, c) any brother or sister of the individual, and d) any spouse of any individual described in b) or c). Control is defined to mean the holding of at least 50 percent of the equity interests, capital or profits interest or *any interest as a general partner*. [209]

The proposed regulations add that in determining whether the family controls the entity, non-family members are ignored unless they have owned an interest in the entity for at least three years constituting 10 percent of the value of all the equity interests in the entity, non-family members collectively own at least 20 percent of the equity interests in the entity, and each non family owner has a put right to receive cash or property equal to at least minimum value within six months of the member's notice of request to withdraw.[210]

4. A "Hypothetical Appraisal" Will be Required

Appraisers say that such transfers will now require two appraisals – one based on generally accepted valuation principles and one based on "hypothetical conditions." Hypothetical conditions are defined under USPAP (Uniform Standards of Professional Appraisal Practice) as "conditions contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of the data used in the analysis." Such hypothetical conditions must be clearly identified in the appraisal report along with the intended use and purpose of the appraisal.

While comments from the appraisal community are still coming in, most say that "even with no restrictions on transfer, and if all applicable restrictions are ignored and we consider all of the named disregarded restrictions, appraisers are left with illiquid minority interests in family partnerships that have investment characteristics that still require analysis to determine their fair market value."[211] Many say that there are plenty of risk factors for both the buyer and the seller left. Some of these may include:

1. Risk that the family members will not invest to suit the buyer's needs;
2. The buyer's inability to control the day-to-day management;
3. The buyer's inability to influence the tax decisions made by the family;
4. The risk to the business if any partner can demand liquidation of his interest at any time;
5. The likelihood that the partners will not allow a redemption;
6. The risk that a C corporation buyer would discount the future cash flow by the income taxes;

[209] IRC §§ 2704(c)(1); 2701(b)(2)

[210] Prop. Reg. § 25.2704-3(b)(4).

[211] Christopher Mercer, Mercer Capital Business Valuation & Capital Advisory Services, VALUATION IMPLICATIONS OF THE PROPOSED CHANGES TO SECTION 2704, Sept. 2016.

7. The cost of liquidating the interest, including two appraisals.
8. The fact that no rational buyer would buy such an interest.

5. Impact on Partnership Redemptions

With respect to the redemption of a family member, the proposed regulations vividly illustrate how they would apply in Example 7 of Prop. Reg. § 25.2704-4(g), as follows:

> *Example (7).* The facts are the same as in Example 5, except, in a transaction unrelated to D's prior transfers to A and B, D withdraws from the partnership and immediately receives the fair market value (but without taking into account the special valuation assumptions of section 2704(b)) of D's remaining 32 percent limited partner interest. Because a gift to a partnership is deemed to be a gift to the other partners, D has made a gift to each child of one-half of the excess of the value of the 32 percent limited partner interest as determined in Example 5 over the consideration received by D from the partnership.

	Ownership Interest	FMV of the Partnership Property	Value of the Interest Assuming a 30% Discount	Value of D's Deemed Gift
D's Interest	32%	$320,000	$224,000	$ 96,000
C's Interest	68%	680,000	476,000	
Total	100%	$1,000,000	$ 700,000	

While this discussion is by no means an exhaustive summary of all the provisions of the new proposed regulations under section 2704, it illustrates the effort the IRS made to value interests in family-controlled entities differently than in non-family settings. The proposed regulations are still subject to many revisions as the comments pour in and commentators debate how they will ultimately affect valuations going forward. However, it is clear that all manner in which a partnership interest can be transferred, directly or indirectly, is in the cross-hairs of these new proposed regulations.

Therefore, practitioners and their clients should act swiftly to make any transfers they wish to make before they are final. But even before they are final, transfers made after their publication are subject to the adequate disclosure rules under Reg. § 301.6501(c)-1(f)(2)(v) and therefore any position contrary to them must be disclosed on a gift tax return.

VI. CONCLUSION

As this outline illustrates, the practitioner who advises his or her client to liquidate a partnership interest or redeem one or more of its partners needs to carefully consider all of the potential income and now gift tax traps embedded in the seemingly simple transaction. He or she must have a working knowledge of partnership income tax, or seek the advice of someone who does. And now, the advisor must also consider the possible gift tax implications that a redemption may have as a result of the new Section 2704 proposed regulations. Between now and when the proposed regulations are finalized may be the best time ever to complete a much needed dissolution or redemption.

Mixing Bowl Flowchart for Partnership Property Distributions
IRC §§ 704(c)(1)(B), 707, 731, 737, and 751
EXHIBIT A