<u>BEYOND 2036:</u>

I. BASIC RULES POST DEATH

A. <u>Closing the Partnership's Books</u>. Under IRC § 706(c)(2)(A), the taxable year of a partnership closes when a partner dies. The question remains, however, whether events such as specific bequests, residuary bequests or other distributions by an estate or living trust would require the partnership to close its books. Guidance needs to be provided as to when the partnership's taxable year is closed in these circumstances.

When a partner dies and terminates his interest in a partnership, 2 different methods are used to allocate items of partnership income. The <u>first</u> is an interim "closing of the books; which effectively separates the partnership year into 2 segments. The first segment is the period prior to the partner's death, the second is the period after the partner's death. Income realized in each segment is then allocated to the persons who were partners during each of those segments.

The <u>second</u> method for allocating partnership income for the year a partner dies is the proration method. Under the proration method, all items of partnership income for the year a partner dies are allocated amongst the partners based on the number of days that year the partner was a partner. Under this method, a deceased (former) partner is allocated a portion of partnership income for the year regardless of when the partnership realizes the income.

Because of the differences in the way each of these methods allocate income between the partners, depending on the particular circumstances, one method may be "better" than the other. Thus, it is imperative that the executor work with the partnership's accountant in selecting the best method of allocating partnership income between the estate and the other partners.

Regardless of which method is chosen, cash basis partnerships must use the accrual method to allocate interest, taxes, payments for services or the use of property other than guaranteed payments under IRC § 83, and any other items specified in the regulations. The partnership is required to assign a portion of these items to each day in the period to which it is attributable. This "daily portion" is then further assigned to the partners in proportion to their respective partnership interests at the close of each day. This mitigates against a partner's ability to time payment of large cash basis expenses (such as real estate taxes and payments for services) for tax purposes. (IRC § 706(b)(2).)

B. Holding Period and Basis. The holding period of a partnership interest automatically becomes long-term by virtue of the basis determination rule under IRC § 1014. (IRC § 1223(11).) Thus, inherited partnership interests have a long-term holding period. However, this rule does not apply to the assets owned by the partnership or within the partnership (inside basis), since the holding period for inherited assets under IRC § 1223(11) does not apply to individual partnership assets. Thus, a partnership must still meet the 1-year holding period to achieve long-term capital gains treatment, even for assets on hand on the day of the decedent's death.

The (inside) basis of partnership assets is determined:

(i) with respect to contributed assets, by the basis of the contributing partner; and

(ii) in a purchase, by the purchase price.

A question exists as to whether a different holding period results when a partnership makes an IRC § 754 election. Pursuant to a § 754 election, the inside basis of the decedent's share of partnership assets is adjusted to equal the fair market value at date of death. In this instance, the decedent's basis in his or her share of partnership assets is determined by IRC § 1014. According to IRC § 1223(11), where a property's basis is determined under IRC § 1014, it is automatically considered to be held for more than 1 year. Thus, the decedent's long-term holding period should "tack" to the partnership assets when an IRC § 754 election has been made.

The (outside) basis of a decedent's partnership interest is adjusted to the date-of-death value.

C. Determining Value and Basis. Although, as discussed above, a deceased partner does not adjust his share of basis in partnership assets to fair market value upon his death, there are exceptions to this rule. Therefore, it is imperative that the executor and the partnership coordinate and discuss the fair market value of the partnership assets on the date of death. This information is mandatory when analyzing whether to make an IRC § 754 election, which is discussed in more detail below. It is also necessary in determining whether the partnership is subject to the new mandatory basis and adjustment rules added by the American Jobs Creation Act of 2004 (the "Jobs Act"). Typically, the accountant prepares an analysis of the basis of each partnership assets versus its date of death fair market value. Additionally, if discounts for lack of marketability or minority interests are being utilized, they need to be evaluated as well.

D. IRC § 704(c). As a general rule, whenever 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 fair market value. This difference is referred to as "built-in gains and losses." Under the Regulations, these "built-in gains and losses" must be tracked on a property-by-property and partner-by-partner basis. When the partnership disposes of property which contains built-in gains or losses, they must be specifically allocated to the contributing partner. Only after this allocation may any remaining gain or loss be allocated among the (other) partners according to their partnership interests.

The IRS wanted to prevent manipulation of tax or shifting tax benefits or burdens among the partners, hence these rules were applied. (Treas. Regs. 1.704-3(a)(1), (2).) Because this can cause a severe recordkeeping burden, particularly with multiple properties, partners, etc., some types of property can be aggregated. Additionally, the regulations allow certain "small disparities" between value and basis to be ignored. These rules are discussed under Treas. Regs. 1.704-3(e)(1), (2).

Obviously, if an IRC § 754 election is made when a partner dies, the tracking of built-in gains and losses is no longer necessary for the deceased partner. This is because this election causes the decedent's basis in the partnership assets to be adjusted to their date of death values, causing the deceased partner's inside and outside basis to be the same. In effect, this election "wipes out" any built-in gains or losses. Note, however, this is only as to the deceased partner -- the §754 election has absolutely no effect on the other partners. Therefore, it is mandatory that built-in gains and losses be tracked.

On gifts of partnership interests, the donee receives a carryover basis. This means that the donee receives the same outside and inside basis of the donor. Similarly, any built-in gains that the donor had attributable to his or her interest under IRC § 704(c) also transfers to the donee. The same rule applies for the transfer of built-in losses, but only for contributions of built-in loss property on or before October 22, 2004. (See IRC § 704(c)(1)(C), added by the Jobs Act, discussed below.)

A partner's profit and loss sharing ratio and his or her allocation of built-in gains and losses may differ when the partner acquires his or her interest partly by gift and partly by personal contributions. After October 22, 2004, built-in losses on assets are subject to special rules and need to be tracked separately. IRC 704(c)(1)(C) allows only the contributing partner to use pre-contribution losses on property contributed after October 22, 2004. This means the partnership must track built-in-loss property contributed after October 22, 2004. There is no de minimus exception for small built-in losses. These rules are discussed in more detail below.

II. MORE ON BASIS AND DISTRIBUTION RULES

Generally, neither the partner nor the partnership recognizes gain or loss on the distribution of money or property to a partner. There are, however, many exceptions. These are discussed in more detail below.

A. Built-in Loss Rules (Effective October 23, 2006). The Jobs Act implemented 3 new mandatory basis adjustment rules designed to prevent partners and partnerships from duplicating losses. They were designed to prevent a technique whereby a partnership would distribute low basis property to liquidate a high basis partner's interest, leaving the high basis property in the partnership. The partner who was liquidated would step-up his or her basis in the property distributed to equal his or her outside basis (which was high). This would leave both the partnership and the partner with high basis property that either could sell, reducing the gain. In these cases, no downward adjustment was required unless the partnership had previously made an IRC § 754 election. Partnerships, in effect, could pick and choose whether to elect or not, and when to make the downward election, all to their advantage. Thus, 3 new rules were implemented which will affect family entities. Bear in mind, however, these rules in and of themselves do not trigger recognition of gain or loss; they merely require the partnership to make certain adjustments to the bases of its assets.

1. IRC § 743. The first rule applies when a partner dies or transfers an interest in a partnership and the partnership has built-in losses greater than $250,000 (a "substantial built-in loss"—measured by netting all the built-in gains or losses in the partnership) (IRC §§ 743(a) and (b)). Thus, if a partnership has significant built-in gains to offset built-in-losses, reducing the built-in-losses below $250,000 after aggregating all built-in gains and losses on partnership assets, the rule will not apply. If the rule applies, the partnership must adjust (up and down), the partnership properties' basis with respect to the transferee to equal the transferee's outside basis in his or her partnership interest. There is no de minimis rule. Hence a transfer of any size due to sale, exchange or death requires that an adjustment be made.

The estate must notify the partnership in writing within 1 year of the partner's death. In a sale or exchange, the transferee has only 30 days from the transfer to so notify. The partnership must attach a statement in the appropriate year outlining the adjustment. This adjustment must be allocated among the assets, just as if a direct purchase by the transferee were made. In effect, it is a "forced § 754 election, even if the partnership did not so elect.

This rule creates problems and uncertainties with family entities. Due to the use of discounts on death, even though the deceased partner's basis is irrelevant under the IRC § 732(d) rules, and does not affect the $250,000 floor, the discounts may affect the size of the (mandatory) basis adjustment. This becomes more problematic due to the chance that values may change on audit, leaving the partnership in a quandary as to the size of the adjustment. There are also many unanswered questions that need guidance from the IRS such as how to count basis for built-in loss property contributed post October 22, 2004, and whether prior 754 adjustments count as part of the basis.

2. <u>IRC § 734(b)</u>. The <u>second rule</u> under IRC § 734(b) requires basis adjustments in 2 situations. The <u>first</u> is liquidating distributions where a partner recognizes a loss because the <u>cash</u> received is less than the partner's (outside) basis in his or her partnership interest. In this case, under IRC § 734(b)(2)(A), the partnership is required to adjust the basis of its other assets. The <u>second</u> is liquidating distributions of <u>property</u>, where the partner steps-up his or her basis of property received in the distribution to equal his or her basis in his or her partnership interest. Under IRC § 734(b)(2)(B), the partnership is required to make a positive adjustment to the basis of distributed property on liquidating distributions exceeding $250,000. Prior to the Jobs Act, unless a 754 election was in effect, none of these distributions required the partnership to adjust the basis of its assets.

The typical scenario under which this new rule applies is where a liquidating distribution of cash or property is made to a high basis partner. Under the prior rules, a basis adjustment was elective. The new rules now mandate a reduction in the basis of partnership property, once again, in effect, forcing a § 754 election. Note, however, positive adjustments are <u>not</u> required.

For partnerships that have not already made § 754 elections, it may be advisable to make one in the year that a distribution under the rules forces the partnership to make a negative basis adjustment, as it would give the partnership the opportunity to elect to make positive adjustments as well.

Another scenario that comes into play is when a partner's adjusted basis increases due to a death, but no election is in effect and the partnership subsequently distributes cash or low basis property to that partner to liquidate his or her interest. This is a trap for the unwary because the new rule incorporates the step-up under IRC § 1014. Since the new basis reduction rules apply, there is a lower downward basis adjustment on the asset distributed than there would have been had a § 754 election been made. If a § 754 election is made on low basis property, the inside basis and outside basis stepped-up under § 1041 are closer and less of a downward adjustment occurs.

Obviously, if a § 754 election is made as soon as the issue arises, then the "extra" basis reduction in the current year is avoided. Additionally, the partnership can then increase the basis of its property for use at a later time when high basis property is distributed to a low basis partner. In any event, the election must be fully analyzed since, once made, it will impact all future transfers, deaths and distributions (which causes increased cost). One must weigh the cost of a § 754 election with the timing issues if no § 754 election is made.

3. Multiple Rules. The third rule involves several codes sections—IRC §§ 704(c)(1)(B), 737 and 731(c). These sections impact family entities even though such entities were not the "target." The rules were actually aimed at transactions where partners arranged to pool their assets in a partnership, then made allocations or distributions in a manner that effectuates a shift in tax attributes. To most taxpayer's surprise, these rules tax the contributing partner, not the partner who receives the distribution.

a. IRC § 704 (c)(1)(B). Under IRC § 704(c)(1)(B), if a partnership distributes to a non-contributing partner, within 7 years of contribution, property in which a contributing partner has built-in gain or loss, the contributing partner must recognize gain or loss. The partner who receives the property has no recognition. The gain or loss recognized is limited to the contributing partner's pre-contribution gain or loss, and the basis in his or her partnership interest is adjusted accordingly. The gain or loss recognized by the contributing partner has the same character as if the partnership had sold the property to the distributee. These rules require the partnership to track, property by property, all pre-contribution gains and losses for 7 years from date of contribution (to date of distribution).

b. IRC § 737. This section taxes a partner that receives a distribution of any partnership property within 7 years of when that partner contributes any other appreciated property to the partnership. The purpose of this section was to ensure that partners did not avoid recognizing their IRC § 704(c) gains by "cashing out" their interest in the partnership with other property while continuing ownership of the IRC § 704(c) property of the partnership. Unlike IRC § 704(c), this section taxes the partner who actually receives the distribution. Gain under this section is limited to the difference between the property's fair market value over the partner's basis in his or her partnership interest. Section 704(c) ignores the contributing partner's basis in his or her partnership interest. IRC § 737 does not apply to distributions of property that a partner previously contributed to the partnership, and it cannot result in a loss. The character of gain recognized by the distributee partner is determined at the partnership level, as if the partnership sold the property in question to an unrelated third party. (It is likely that most property in a family entity will be characterized as long-term capital gain.)

c. IRC § 731(c). For distributions of marketable securities made after December 8, 1994, some or all of the securities may be treated as money under either of 2 circumstances. The first is for purposes of determining whether a partner recognizes any gain under IRC § 731(c) when the amount of money received is greater than his or her (outside) partnership basis. The second is where securities are distributed to a partner with pre-contribution gain within 7 years of that partner's contribution of the IRC § 704(c) property. Here, IRC § 731(c) applies before IRC § 737, and only the portion of securities not treated as money under § 731(c) is taken into consideration under § 737.

The "marketable security" definition under IRC § 731(c)(2) is more narrow than the definition under IRC § 351(e). IRC § 731(c) is targeting cash equivalents, while § 351(e) targets all stocks and securities.

If the fair market value of a distributed security is greater than the partner's basis in the partnership interest, then the portion treated like a cash equivalent is reduced by the partner's share of unrealized gain in those securities. The regulations state that all the partnership's marketable securities are in the same class. Thus, the difference between the partner's unrealized gain in securities before and after the distribution reduces the value of the distributed securities treated like cash.

There are 3 exceptions under IRC § 731(c)(3)(A):

1. Securities are not treated as money if distributed to the contributing partner.

2. Securities are <u>not</u> treated as money if the property was not a security when the partnership acquired it.

3. Securities are <u>not</u> treated like money when distributed by an "investment partnership" (engaged in a trade or business other than investing) to an "eligible partner" (one who has only contributed investment-type assets).

d. <u>Mixing Sections</u>. It is possible to invoke §§ 704(c)(1)(B), 731(c) and 737 at the same time, i.e., if a security with a built-in gain or loss on contribution is distributed to a partner who has a built-in gain or loss account created within the last seven years. In this case, IRC § 704(c)(1)(B) will tax the contributing partner as if the property were sold at fair market value on the date of distribution. IRC § 731(c) taxes the distributee partner to the extent that the money exceeds the partner's basis in his partnership interest. Last but not least, IRC § 737 taxes the distributee partner to the extent the fair market value of the property portion of the securities is greater than his basis in the partnership. These statutes are applied in the following order: § 704(c)(1)(B), § 731(c) then § 737.

III. § 754 ELECTIONS

When a partner dies, his or her basis in the partnership is adjusted to equal the fair market value at date of death, <u>reduced</u> by income in respect of a decedent attributable to that interest. In essence, the partner receives a step-up on his outside basis but none on his or her inside basis unless the partnership makes a 754 election. If a § 754 election is made, however, that partner's share of the inside basis is similarly stepped-up. The decision as to whether this election should be made is difficult and complex.

The election is made by attaching a statement signed by any partner to the partnership tax return in the year of the partner's death. The election is irrevocable without IRS consent to revoke. (Treas. Regs. § 1.754-1(b) and (c).)

A late election can be made by filing a return, attaching the election, and stating at the top of Form 1065 or the election statement, preferably both, "this is filed pursuant to Treas. Reg. § 301.9100-2." Late elections must be filed within 12 months of the due date (including extensions) of the partnership return filed in the year of the decedent's death. For example, if a partner dies in 2006, the election must be made by April 15, 2008, unless the partnership return for 2006 was extended.

In weighing whether an election should be made, all issues must be considered (there are pros and cons). Since the election really only causes a timing difference, one needs to determine whether the burdensome recordkeeping cost is outweighed by a looming benefit. If the partnership has no intention of selling any significant assets in the near future, no tax savings will result until the property is sold. Similarly, if the deceased partner's estate sells out, then only the outside basis will be used and the inside basis is not needed. On the other hand, if the partnership itself is contemplating a sale of a larger asset, then it may be advisable. Once the election is made, it will apply at each partner's death and when the partnership makes other distributions.

The election should <u>not</u> be made if the value of the partnership's assets will be less than the partnership's cost basis in the assets as, if such an election was made, a reduction in basis will occur. This can happen where discounts are utilized in valuing partnership assets. Unfortunately, under the Jobs Act, this election may be "mandatory" if the inside basis of all partnership property exceeds its fair market value by more than $250,000. This test uses the fair market value of partnership property, not a discounted basis of the outside interest.

It is advisable to postpone the § 754 election decision if there is an estate tax audit. Prior to audit, the election may cause a step-down in basis. However, if an audit raises values, then the election may increase basis post-audit. Additionally, amended returns may be needed depending on the outcome of the audit and the § 754 decision.

If the § 754 election is made, the regulations lay out the allocation rules and the method of allocating a transferee's basis in his or her partnership interest among his or her share of the partnership assets. The regulations attempt to achieve the desired goal of bringing uniformity between a partner's inside and outside bases. The regulations provide a <u>3-step process</u>:

1. Calculate the difference between the partner's basis of his partnership interest and his or her share of the adjusted basis of partnership property (the "743 adjustment").

2. Allocated all assets into 2 categories—ordinary and capital gain. Apply the adjustment, first, to make all ordinary income property equal to its fair market value. Once ordinary income property has been adjusted to its fair market value, the balance is allocated to the capital gain assets.

3. Within each class, allocate the step-up or step-down on an asset-by-asset basis, based on the taxable gain or loss that would be allocated to the transferee from a hypothetical sale of each asset. (Treas. Regs. § 1.743-1 and 755-1.)

The regulations are silent on how to allocate discounts based on lack of marketability and minority interest assumptions to the value of partnership assets. One may be able to use an example in the regulations involving the sale of a partner's interest for less than his pro rata share of the fair market value of the underlying assets. In this example (Treas. Reg. § 1.744-1(b)(3)(iii)2), the ordinary income asset receives a full step-up and the capital gains assets bear the reduction. Thus, in a family partnership, it would appear that partnership discounts should be allocated among the capital gain assets based on their relative value.

A final consideration is the impact in a community property state. Although § 754 seems, on its face, to <u>not</u> apply to the surviving spouse, IRS has ruled otherwise. In Rev. Rul. 79-124, 1979-1 C.B. 224, the IRS has stated that the § 754 basis adjustment also applies to the surviving spouse's share in a community property state. This is favorable to taxpayers, simplifies bookkeeping between the deceased and surviving spouse, and is another factor in determining whether such an election should be made.

An alternative to § 754 is IRC §732(d). If a partnership which has not made a § 754 election distributes property to a partner within 2 years of when that partner acquired his or her interest by purchase or death, the distributee partner may elect to calculate the basis of distributed property under IRC § 743 as if a § 754 election had been made. Without the § 732(d) election, the distributee calculates the basis of distributed property under the rules of §§ 732(b) and 732(c). Although both methods allocate a partner's outside partnership basis to the distributed property, the rules for allocation <u>among the assets</u> differ. Generally, § 743 allocates based on fair market values, whereas § 732(c) allocates according to basis. In the event that the partnership could benefit from an allocation under it, an added advantage is that the § 732(d) election imposes no obligation on the partnership to adjust the basis of its other assets, as does the § 754 election.