Momma Told Me Not to Do That: Our Discount for Estate Tax Purposes was Allowed, how Come we Now have to Pay More Income Taxes?

The exit times from family limited partnerships are two fold, during life or at death. And the exit strategy most often applied is complete liquidation of the partnership and distribution of partnership assets. This is particularly true with a family partnership that is made up primarily of marketable assets (a "MAP," or "marketable asset partnership").

As more family partnerships are reaching maturity (maturity in this case being the passing of our clients), practitioners are encountering an area we always knew would be challenging, post mortem liquidation of MAPs. For this month's column, we drill down on a prevalent issue in estate planning today: the effect of the estate tax discount on the beneficiaries' basis in their partnership assets when the partnership is dissolved and its assets distributed.

A. <u>Income Tax Effects at Death of Reduced Basis at Some Points</u>

For income tax purposes, at death the beneficiaries take as their basis in capital assets the then fair market value of those assets. If a partnership interest is discounted for estate tax purposes, the basis in that partnership is equal to that discounted value. By definition, that discounted value will be less than the fair market value of the underlying value of the assets.

We do not often advise clients that this discrepancy takes away a bit of the tax savings, but that is in fact what happens.

> *Example 1: If the underlying value of the assets in the partnership is $1,000,000 (with a tax basis of $100,000) and there were no partnership, there would be a step up in basis equal to $1,000,000 on the assets at the decedent's passing. I.R.C. section 1014. If, on the other hand, the property is transferred to a partnership, and a 40% discount on value is achieved, the partnership property in the gross estate is now valued at only $600,000. And under section 754, the step up in inside basis can be made equal to the outside basis, or stepped up to $600,000. The difference between the first step up (without the partnership), $1,000,000, and the partnership step up, $600,000, is now subject to capital gains taxes at some point. That difference is $400,000, times a combined federal and state cap gains rate of say 18%, results in additional income tax of $72,000. So the estate tax savings by reducing value by $400,000 (which could be about $140,000 under a 35% marginal tax rate) needs to be compared with the increase in income tax of $72,000 to determine the net effect of the tax strategy.*

B. <u>But Beware: Even High Basis Assets have Bad Results</u>

Most practitioners are willing to accept the results in Example 1 because losing a tax benefit is an opportunity cost, not a real loss. In Example 1, the estate merely didn't get a full step up. A partial step up, coupled with an estate tax discount, could be considered a win-win.

But since 2008, portfolios with appreciated assets may have turned into portfolios with depreciated assets (built in losses), or portfolios with high bases compared to fair market values. Practitioners now need to consider the income tax impact of these high basis or built in loss portfolios in their family limited partnerships. And the impact is not pretty.

As an initial matter, we need to make sure the liquidation of a marketable securities partnership avoids gain on dissolution.

C. I Want My Partnership Assets Now that Mom Has Died

In terminating a MAP post mortem, the initial question is whether there is any gain with a distribution. In operating partnerships with real estate or other business operations, there is typically no gain on liquidation and distribution of assets. This is because section 731 provides that there is no gain recognized when a partnership makes a distribution to a partner unless the amount of "cash" distributed exceeds the distributee's tax basis for the partnership interest.

In a MAP, the result could be different. "Cash" includes marketable assets. With a MAP then, the fair market value of the full distribution will be considered. And to avoid gain, that needs to be less than or equal to partnership basis. At first blush, a practitioner may conclude that because of Code section 1014, and because the estate received a step up in basis, the amount of "cash" to be distributed will not exceed its basis. Not true because of the discount taken for estate tax purposes.

In example 1, there is a disparity of $400,000 between fair market value and basis. In that example, the value of the "cash" distributed will be greater than the outside basis, the discounted value of the partnership interests in the estate at death.

Without an exception to the gain rule in 731, the termination and asset distribution will trigger gain. Code section 731 (a) (3)((A)(iii) provides that exception to the gain rule for investment partnerships:

> "(3) Exceptions
> (A) In general
> Paragraph (1) shall not apply to the distribution from a partnership of a marketable security to a partner if -
>
> (iii) such partnership is an investment partnership and such partner is an eligible partner thereof.
>
> For purposes of subparagraph (A)(iii):
> (i) Investment partnership
> The term "investment partnership" means any partnership which has never been engaged in a trade or business and substantially all of the assets (by value) of which have always consisted of -
> (I) money,
> (II) stock in a corporation,
> (III) notes, bonds, debentures, or other evidences of indebtedness,
> (IV) interest rate, currency, or equity notional principal contracts,

> (V) foreign currencies,
> (VI) interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described in any other subclause of this clause or in any commodity traded on or subject to the rules of a board of trade or commodity exchange,
> (VII) other assets specified in regulations prescribed by the Secretary, or
> (VIII) any combination of the foregoing."

With a MAP, the partnership should qualify for this exception: the partnership is not engaged in a trade or business, almost all assets consist of money, stocks, and other publicly traded securities, and essentially only family members have been members.

D. Section 731 is Only the Beginning in Determining Whether There is Gain on Liquidation and Distribution

Section 704 provides that if built in gain property contributed by one partner is distributed from the partnership to another partner within 7 years of contribution, that built in gain is recognized to the contributing partner as if the property had been sold by the partnership. The good news here is that the distribution to the estate is treated as being distributed to the decedent (the estate and the decedent are treated as the same entity for purposes of determining if section 704 is invoked). Therefore, there should be no triggering of the built in gain here.

E. Phew, No Gain: My Life is Complete, or is It?

Assuming there is no gain on dissolution, this is not the end of the story. Surprised? Most practitioners are; and brokerage houses often do not focus on basis adjustments needed on dissolution and distribution (nor should they necessarily).

Keep in mind that the discounted value of the limited partnership interest will be less than the fair market value of the actual assets in the partnership, in the aggregate for estate tax purposes. See example 1. The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is equal to the adjusted basis of such partner's interest in the partnership, reduced by any money distributed in the same transaction. I.R.C. section **26 CFR § 1.732-1**. Because the outside fair market value is discounted, the basis of the distributed assets will be reduced to that discounted value.

> *Example 2: Assume the underlying value of the assets in the partnership is $1,000,000 (with a tax basis of $1,000,000). At a 40% discount on value is achieved, the partnership property in the gross estate is now valued at only $600,000. Ponders what happens on liquidation. Assume the partnership has always been a marketable asset partnership and that at dissolution, there is no gain even though the fair market value of the assets is $1,000,000, and the outside basis is $600,000. Going forward the basis of those assets gets decreased from what they were in the partnership. The reduced basis should be equal to the outside basis, or $600,000. Essentially, clients may be surprised to learn that assets that had no built in gain now, in fact, do have a built in gain (of $400,000).*

Where this gets more bizarre is when the portfolio consists of cash or bonds.

Example 3: Assume the portfolio is 100 % in bonds, with a fair market value of $1,000,000, but the partnership is valued at $600,000 for estate tax purposes. When the partnership is dissolved and distributed, the bonds should have a basis on the new brokerage accounts of $600,000. Often times, the account will carry over the basis reported for partnership purposes, at $1,000,000. Who is advising the brokerage house of this new basis of $600,000? And what if the partnership consisted of only cash?

F. <u>Communication is Key</u>

The important item is that in setting up these partnerships, communicating at the outset that there will eventually be a capital gains tax when assets are sold, anticipated to be after the partnership is dissolved (if not before), is a key part of the initial planning discussion. Reminding the family of this during the dissolution process will be prudent and protective to the practitioner.

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