ESTATE & SUCCESSION PLANNING CORNER—Discounts vs. Step-Up Basis: Tax Rate Arbitrage Gone Bad (or Not as Good as Expected)?

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Income Tax vs. Estate Tax Planning

In 2014 and going forward, income tax planning in estate planning will be parallel in importance to estate tax planning. For estate planners, planning for the step-up in basis (until that too is repealed) is a critical step. And in the partnership context, that step becomes critical. Typically, discounts for estate tax purposes reduce the potential step-up in basis and are therefore costly from an income tax perspective. That increased income tax burden will become apparent when a partner exits from the partnership.

Exiting a family limited partnership ("FLP") can occur during a client's life or at the partner's death. The exit strategy most often utilized is complete liquidation of the FLP and distribution of its assets. This is especially true with an FLP that holds primarily marketable assets, referred to as a marketable asset partnership ("MAP").

Prior to 2014, a primary focus in discussing FLPs as a strategy to clients—in addition to achieving important business purposes—creditor protection, family control of assets, consolidation of investments, retention of certain assets, diversification of others, other investment reasons, spousal protection—was on achieving valuation discounts for minimizing the client's federal estate tax ("estate tax").

Often unsaid, or at least not well explained or emphasized, to clients was and is the fact that any achieved estate tax savings would be later offset by higher income taxes on the ultimate beneficiaries of the FLP interests. Effective in 2013, it could also be offset by the burden of additional net investment income ("NII") taxes imposed on unearned income.[1]

In reality, FLPs have always been a form of tax rate arbitrage, whereby the client is accepting increased income (and possibly) NII taxes at a collectively lower tax rate for the client's beneficiaries in exchange for a reduction in the client's estate taxes at a higher tax rate. While the arbitrage may still prove beneficial from an overall tax standpoint, the net value may not be as substantial as anticipated. Furthermore, the income and, if applicable, NII tax hits will come as a surprise to many unsuspecting beneficiaries of such an interest.

As more FLPs reach maturity—here being the passing of our clients—practitioners must grapple with the challenging issue of the post-mortem liquidation of MAPs, the time at which the undesirable income and Medicare tax consequences of discounted MAP interests may surface. This issue's column focuses on the effect of the estate tax discount attributable to a MAP interest on the beneficiaries' income tax basis in the assets distributed to them upon the entity's liquidation and dissolution. In doing so, we explain how this effect, while not eliminating the rate arbitrage benefit of a FLP, may reduce it significantly.

Discount Now, Pay Later

While the discounted value of a MAP interest produces estate tax savings of 40 percent[2] for each dollar of discount, such discounted value impacts the income tax basis to the beneficiaries of the MAP interest they receive on the client's death.

At death, beneficiaries normally take a basis equal to the fair market value ("FMV") of the assets received,[3] referred to as "step-up basis," not the decedent's basis. If the FMV of a MAP interest is discounted for estate tax purposes, the basis in the MAP interest received by the beneficiaries will be equal to that discounted value.[4] By definition, that discounted value will be less than the FMV of the underlying assets held by the MAP. That difference causes the beneficiaries to recognize gain for income tax purposes upon the post-mortem liquidation of the MAP. Such gain may also generate NII taxes. The income and NII taxes resulting from the gain offsets some, perhaps much, of the estate tax savings.

BLOCK QUOTE: Example 1: Assume that a client, Mom, holds marketable assets in her own name with a FMV of $1 million and an income tax basis of $100,000 at the time of her death. The equal beneficiaries of her assets, her two children, would take a collective step-up basis for income tax purposes equal to $1 million. If the children were then to immediately sell the assets for $1 million, they would experience no realized gain or loss on the sale and, thus, they would experience no income or NII tax consequences.

BLOCK QUOTE: What if, instead, Mom transferred the marketable assets to a MAP? Now, the underlying value of the assets in a MAP would be $1 million and Mom's income tax basis in the MAP interest ("outside basis") would be $100,000. However, suppose that a 35-percent discount is appropriate in valuing her MAP interest for estate tax purposes. The MAP interest included in her gross estate would be valued at only $650,000 [$1 million – $350,000 valuation discount ($1 million x .35)]. At a 40-percent estate tax rate, this would produce estate tax savings of $140,000 ($350,000 x .40). So far, this all looks good. Eventually, however, will come some bad, the only uncertainty is how much.

BLOCK QUOTE: Upon Mom's passing, the two children decide to liquidate and dissolve the MAP.[5] The estate tax valuation of $650,000 becomes the children's collective outside basis in the MAP interest for income tax purposes. When the MAP makes a *pro-rata* distribution of its assets, worth $1 million collectively, to the children, they will experience a collective realized gain of $350,000, but none of this may be recognized due to a special rule underlying liquidating distributions from investment partnerships (discussed *infra*). The children will take a basis in the assets distributed in the MAP equal to the outside basis of the children's interests in the MAP, collectively $650,000, reduced by any actual money distributed to them in the same transaction, here assumed to be zero, or $650,000.

BLOCK QUOTE: If the children were to then sell all of the distributed assets for FMV, they would generate a collective realized and recognized gain of $350,000 ($1 million amount realized - $650,000 adjusted basis). The gain would be capital in nature since the assets were held for investment.[6] As inherited assets, the holding period of the capital assets would be deemed to be long-term,[7] resulting in long-term capital gain ("LTCG"). LTCG is subject to a maximum preferential tax rate, which varies depending on the taxpayer's normal marginal income tax rate. A zero-percent rate applies to taxpayers with a normal marginal rate of either 10 or 15 percent; 20 percent applies to taxpayers with a normal rate of 39.6 percent; and 15 percent applies to taxpayers with normal rates between 15 percent and 39.6 percent.[8]

BLOCK QUOTE: Suppose that children both had a normal marginal rate of 39.6 percent such that the preferential rate on the $350,000 of LTCG generated by the liquidating distribution is 20 percent. This means that the children would collectively pay $70,000 ($350,000 x .20) of additional income taxes as a result of the estate tax discount. But, the story does not end there. Since LTCG are a form of unearned income,[9] the $350,000 potentially would be subject to an NII tax of 3.8 percent or $13,300 ($350,000 x .038). Further, if the beneficiaries are subject to state income taxes, the LTCG would be subject to state income taxes. So, for example, suppose that both of the children resided in a state with no estate tax (thus, the $350,000 estate tax discount would have produced no state estate tax savings) but has a flat income tax rate of five percent. The LTCG would result in additional state income taxes of $17,500.[10] The grand total of additional income and Medicare taxes on the children would be $100,800 ($70,000 + $13,300 + $17,500). While the estate tax savings of $140,000 due to the discounted MAP interest seem impressive when viewed in isolation, they seem much less so once the eventual impact of the income and Medicare taxes on the children is considered.

Practitioners may be willing to accept these results—avoid tax now for some tax burden later. After full disclosure and explanation, clients may be fine, too, with the strategy. But disclosure is critical to avoid surprises and questions (from the client's family members) down the road.

The partial step-up in basis for the beneficiaries (from the client's outside basis in the MAP of $100,000 to the discounted value of $650,000 at date of death), coupled with the $350,000 estate tax discount resulting from the FLP strategy, produces a net overall tax savings of $39,200 ($140,000 of reduced estate taxes – $100,800 of increased income and NII taxes). It may not be a win-win, but the estate tax victory still overcomes the income and NII losses. In those cases where there is a step-down in basis—partnership funded with bonds, for example—the practical results of moving forward may not be as attractive.[11]

Does the Analysis Change if the Assets are not Appreciated in Value?

In Example 1, the MAP's underlying assets had a low basis relative to FMV. On surface, one might conclude that this is what caused the backside negative income and NII tax consequences to the beneficiaries. But, this is not necessarily true.

In recent years, the potential for encountering portfolios with assets that have depreciated in value, such that basis exceeds FMV, or in which there is no appreciation, such that basis equals FMV, has been great. Intuitively, one might conjecture that such portfolios would not produce any of backside negative income and NII tax consequences the beneficiaries experienced in Example 1. Unfortunately, that is not true. Here's why.

Can I Please Have My Partnership Assets Now that Mom Has Died?

While succinct, the analysis in Example 1 does not provide an adequate basis for fully understanding the resulting income tax consequences associated with the post-mortem liquidation of a MAP. The following discussion sheds a bit more light on the area.

Code Sec. 731 provides the general rules governing the recognition of gain or loss on a distribution of partnership assets in a liquidating distribution. Under Code Sec. 731(b), the partnership recognizes no gain or loss on such distributions. Under Code Sec. 731(a), the partner recognizes no gain on the distribution except to the extent that cash distributed exceeds the partner's outside basis immediately before such distribution.[12] Loss is recognized by the partner only on the receipt of money, unrealized receivables and inventory.[13] For both gain and loss purposes, "cash" may include marketable assets.[14]

In operating partnerships with real estate or other business operations, the partners typically experience no gain on liquidation and distribution of assets because there is often little cash to distribute in such partnership. Thus, the cash distributed to each of the partners typically does not exceed his or her outside basis in the partnership.

With a MAP, the analysis gets more complicated. Since a MAP's assets are typically comprised of cash and/or marketable assets, all of the assets distributed may be deemed "cash." At first blush, a practitioner may conclude that because a beneficiary receives a partial step-up (to the discounted value used for estate tax purposes), the amount of cash to be distributed will not exceed its outside basis. But, this is not true due to the discount taken for estate tax purposes.

In Example 1, there is a disparity of $350,000 between the FMV of the underlying MAP assets and the children's collective outside basis in the MAP interests, the discounted value of the MAP interests in the Mom's estate. In that example, the value of the deemed cash distributed, $1 million, will be greater than the children's collective outside basis, $650,000.

Without an exception to the gain recognition rule in Code Sec. 731(a), the liquidation and asset distribution would result in $350,000 of collective recognized gain to the children. Code Sec. 731(a)(3)(A)(iii), however, provides such an exception. Under that provision, the children would recognize no gain so long as the distribution was made by an (1) "investment partnership" to an (2) "eligible partner."[15] A partnership qualifies as an "investment partnership" if it has never been engaged in a trade or business and if substantially all[16] of the entity's assets, by value, have always consisted of cash or investment-type assets listed in Code Sec. 731(c)(3)(C)(i)(II)–(VIII).[17] This includes corporate stock; notes; bonds; debentures or other evidences of indebtedness; interest rate, currency or equity notional principal contracts; foreign currencies; certain interests in or derivative financial instruments; other assets specified in regulations; and any combination of any such assets.[18]

An "eligible partner" is a partner who, before the date of distribution, had never contributed any noninvestment type assets to the partnership.[19]

Typically, a MAP should qualify for this exception. Usually, a MAP will be an "investment partnership" because it is not engaged in a trade or business, and almost all—if not all—of the MAP's assets consist of money, stocks and other publicly traded securities. The distributee partners, the beneficiaries of the MAP interests, generally will not have made any contribution of assets to the MAP or, if so, such contributions would have been cash or investment-type assets. This makes each of them an "eligible partner." As such, liquidation distributions of MAP assets generally should result in no gain recognition to the distributee partners.[20]

But Wait, There Are More Possibilities for Gain

Even if the investment partnership exception applies, there are two other provisions that seemingly could cause the distributee partners to recognize gain on the liquidation of a partnership: Code Secs. 704(c)(1)(B) and 737.[21] Under Code Section 704(c)(1)(b), if a partner contributes appreciated property (*i.e.*, FMV exceeds basis, such that there is "built-in gain") to a partnership and such property is distributed to another partner within seven years of such contribution, the contributing partner must recognize gain or loss as if the property was sold at its FMV on the date of distribution.[22]

Thus, in Example 1, if the liquidation of the MAP occurred within seven years of Mom's contribution of the marketable assets to the MAP, it would appear that the children may have to recognize gain. Fortunately, that is not the case. Regulations provide that a transferee partner, here both of the children, "steps into the shoes" of the transferor partner, here the Mom, for Code Sec. 704(c) purposes.[23] Thus, even if Mom had contributed the appreciated marketable assets to the MAP and the entity distributes such assets to the children (as beneficiaries of Mom's MAP interests) within a seven-year period, no gain would be recognized. The distributions are not being made to "another partner" since the children step into Mom's shoes. Since Mom and the children are treated as one and the same partner, there should be no triggering of the built-in gain (assuming a *pro rata* distribution of each security).

Code Sec. 737 supplements Code Sec. 704(c)(1)(B). It applies if a partner contributes appreciated property to a partnership and then within seven years of such contribution, receives a distribution of other appreciated property.[24] Thus, like with Code Sec. 704(c)(1)(b), it would seem that the children in Example 1 might have to recognize gain on the liquidating distribution. Fortunately, again, that is not the case. The Code Sec. 737 regulations incorporate by reference Code Sec. 704 regulations' "steps in the shoes" rule.[25] As such, Mom and the children would again be viewed as one-and-the-same partners. As such, no gain is triggered.[26]

Phew, No Gain on Liquidation, but What Happens When I Sell Those Assets?

Even on the assumption that there is no gain on the liquidation and dissolution of the MAP, the story does not end. Surprised? Most practitioners probably are.

Pursuant to Code Sec.732(b), 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 actual money distributed in the same transaction. The effect is that the basis of the distributed assets to the beneficiaries in the liquidation of a MAP will be reduced to the discounted value used for estate tax purposes.

BLOCK QUOTE: Example 2: Assume that Mom transferred marketable assets to a MAP. At the time of Mom's death, the FMV of the underlying MAP assets and Mom's outside basis in the MAP interest are both equal to $1 million. That is, there is neither appreciation nor depreciation in value. If a 35-percent estate tax valuation discount is achieved, Mom's MAP interest will be included in her gross estate at a value of only $650,000, and the children will take a collective outside basis in their MAP interests of $650,000 (as in Example 1). On liquidation, if the special rule for nonrecognition related to investment partnerships applies, the children will report no gain as a result of the distribution of the MAP assets even though the deemed cash distributed, $1 million, exceeds the children's collective outside basis, $650,000. They will take a collective basis in such assets equal to their collective outside basis immediately before the distribution, $650,000, less any actual cash distributed to them, here assumed to be zero, or $650,000. So, even though the assets in the MAP had no built-in gain (*i.e.*, basis and FMV were both $1 million) because of the estate tax discount the children will take a basis in such assets of $650,000, resulting in a built-in gain of $350,000 ($1 million FMV – $650,000 basis). As in Example 1, once the children sell such assets, this gain will result in LTCG subject to income taxes and NII taxes. Undoubtedly, this will come as quite the shock to the children, as it would to the vast majority of beneficiaries of any MAP.

The problem is exacerbated by the fact that brokerage houses do not (nor would they reasonably be expected to) focus on basis adjustments in marketable assets needed as a result of the distribution of an FLP's assets. As a result, clients will be unprepared for the income and possible NII tax hit that they will face when they sell the distributed assets.

BLOCK QUOTE: Example 3: Assume that the assets held by the MAP in Example 1 consist entirely of corporate bonds, in which the MAP has a basis of $1 million. At Mom's death, the FMV of the bonds is $1 million but, due to an estate tax valuation discount, the MAP interests are valued for estate tax purposes at only $650,000. When the MAP is liquidated and dissolved, the bonds are distributed to the children. They, in turn, establish new brokerage accounts to hold the bonds. The bonds should have a collective basis on the new brokerage accounts of $650,000. Unfortunately, the new brokerage accounts will often-times carry over the MAP's basis of $1 million. The result is that the children (and perhaps their income tax preparers) will likely be unaware of the fact that if the bonds are sold for $1 million, $350,000 of gain will need to be recognized.

Someone should be advising the brokerage house of the new basis. Who should that be? In all likelihood, the children will be oblivious to the issue. The children's income tax preparer, especially if not well-versed in partnership taxation, may be equally oblivious. The preparer will likely rely on the brokerage house for the basis information, which will be erroneous in most cases. This could really be problematic because, on audit, the failure to report the gain will not only result in the assessment of applicable income and NII taxes but also in potentially large amounts of interest charges and penalties. That leaves only one person standing: the practitioner. He or she is the one who advanced the FLP strategy to the client and who would likely be the only one sensitive to and knowledgeable about this issue.

Can I have my Cake and Eat It Too?

For husband and wife planning, the concept of "having your cake and eating it too, without the cake being gone," could be planned for. If a partnership is set up, for all the valid reasons that partnerships are set up, then certain actions could be taken at the first spouse's passing.

Assuming discounts are allowed, the partnerships can be strategically allocated at the first spouse's passing. For example, in a typical limited partnership, the general partnership interests represent five percent of the equity, and the limited partnership interests represent 95 percent of the equity. Strategic allocation of both pieces of the credit shelter trust has immediate estate tax advantages and future income tax advantages.

BLOCK QUOTE: Example 4: Husband passes away owning half of the general partnership interests (2.5 percent) and half of the limited partnership interests (47.5 percent) in a partnership with a face value of $10 million. At a 40-percent discount, the limited partnership interests are worth $2.85 million [$6 million ($10 million - $4 million valuation discount) x .475] and the general partnership interests, at no discount, are worth $250,000 ($10 million x .025). Assume both interests are contributed to the credit shelter trust (now to be funded with $5.34 million of assets in 2014). This allows more funding to the credit shelter trust, as it will have another $2.24 million ($5.34 million - $3.1 million) to fill its coffers.

Now assume that the limited partnership converts to a general partnership as easier to manage and to achieve the same investment objectives. If the credit shelter trust is treated as a grantor trust under Code Sec. 678, the surviving spouse can buy the partnership interests from the credit shelter trust, this time at no discount because the limited partnership interests are gone. The purchase price is $5 million, into the credit shelter trust. The credit shelter trust will now have $7.24 million with full basis. Initially, the basis in the hands of the surviving spouse of the general partnership interest is $3.1 million, a carryover basis ($2.85million + $250,000). At the surviving spouse's passing, however, that basis will get a step up to FMV, or in this example, $5 million. A caveat to this example: the variables can evolve based on the law, and the Code Sec. 678 treatment could be viewed as aggressive.

Communication is Key

When estate tax rates were relatively high and income tax rates were relatively low, ignoring or under-emphasizing the tax rate arbitrage aspects of a FLP was perhaps defensible. However, in the current environment—with increases in income tax rates and the creation of the additional 3.8-percent NII tax on unearned income—it no longer is. The initial planning discussion with a client considering an FLP strategy, including a MAP, should highlight the important fact that eventually there will be income taxes and NII taxes that may result when the assets are sold, anticipated to occur after the MAP is liquidated and dissolved. Reminding the client's beneficiaries of this fact during the liquidation and dissolution process will be prudent and protective to the practitioner. Additionally, advising the beneficiaries of the required basis adjustments resulting from the estate tax discount will serve to ensure that the recognized gain is properly and timely reported by them, so as to avoid any unnecessary interest charges and penalties.

A final item that must now be considered for older partnerships. Are they still needed for estate tax protection? With the applicable exclusion amount increased to \$5.34 million, if a discount partnership is not needed, consider liquidating it or otherwise creating a mechanism so that the discount at passing—and basis step down or reduction—does not occur. This becomes a pivotal step in 2014 and beyond.

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1 The additional 3.8-percent NII tax is imposed on the unearned income of individuals, estates and trusts. Code Sec. 1411. For individuals, the tax is 3.8 percent of the lesser of (1) NII or (2) the excess of modified adjusted gross income ("AGI") over \$250,000 for married taxpayers filing jointly (\$125,000 if married filing separately) and \$200,000 for all other taxpayers. Code Sec. 1411(a)(1). For estates and trusts, the tax is 3.8 percent of the lesser of (1) undistributed NII or (2) the excess of AGI over the dollar amount at which the highest estate and trust income tax bracket begins. *Id.* Generally, NII includes interest, dividends, annuities, royalties, rents, income from a Code Sec. 469 passive activity and net gains from the sale of investment property less expenses deductible in generating such income. Code Sec. 1411(d).

2 Although the unified transfer tax rates contained in Code Sec. 2001(c)(2)(B) reflect progressive rates ranging from a low of 18 percent to a high of 40 percent, because of the applicable exclusion amount (\$5,250,000 for 2013 and recently indexed to \$5,340,000 for 2014), none of the lower rates can apply, effectively resulting in a flat-rate structure of 40 percent.

3 Code Secs. 1014(a) and 1022

4 *Carroll Janis.*, 2007-1 USTC ¶50,210, 469 F3d 256; *Conrad Janis.*, 2006-2 USTC ¶50,512, 461 F3d 1080. For an analysis of these cases and a discussion of the matching of asset values for income and estate tax purposes, *see* Gary D. Rider and Darlene Pulliam, *Matching Asset Value for Income and Estate Tax*, J. ACCOUNTANCY, Sept. 2007.

5 A number of factors may trigger this decision. One such factor, for example, may be that the two children develop irreconcilable differences regarding the investment strategy for the MAP.

6 *See* Code Sec. 1221(a).

7 Code Sec. 1223(11).

8 Code Sec. 1(h)(1). In addition, there are two other LTCG maximum preferential rates that may apply in certain circumstances. A 28-percent rate applies to "collectibles gain." Code Sec. 1(h)(4). A 25-percent rate applies to "unrecaptured section 1250 gain." Code Sec. 1(h)(1)(D).

9 *See* note 1, *supra*.

10 The state income taxes are deductible as an itemized deduction. If each child itemizes, the payment of the taxes would generate federal income tax savings on their individual federal income tax returns to the extent that the taxes are not subject to the phase-out of itemized deductions (also known as the "cutback adjustment") under Code Sec. 68 and, then, only to the extent that the total itemized deductions after phase-out exceed the child's standard deduction. For simplicity, the computation in arriving at the collective federal income tax of \$70,000 ignores the possibility of such savings.

11 Further, all current partnerships should be reviewed to determine if the discount is still necessary in light of the increased estate tax exclusion amount to \$5.34 million.

12 Code Sec. 731(a)(1).

13 Code Sec. 731(a)(2).

14 Code Sec. 731(c). However, the determination of whether the distribution of marketable assets will be treated as a cash distribution is complicated because, among other things, several exceptions apply. For a discussion of these complications, *see* HOFFMAN, RAABE, SMITH, MALONEY & YOUNG, CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS: 2014 EDITION (South-Western Cengage Learning), at 11-12 and 11-13. For purposes of this article, we are assuming that none of the exceptions apply.

15 Code Sec. 731(a)(3)(A)(iii).

16 "Substantially all" is defined to mean 90 percent or more. *See* Reg. §1.731-2(c)(3).

17 Code Sec. 731(a)(3)(C)(i)(I)–(VII).

18 Code Sec. 731(a)(3)(C)(i)(II)–(VII).

19 Code Sec. 731(c)(3)(C)(iii).

20 Even if Code Sec. 731(c) did apply, the amount of recognized gain is limited pursuant to Code Sec. 731(c)(3)(B). For a discussion of this issue, *see* Bryan E. Keenan, *Partnership Terminations: Breaking Up is Hard to*

Do, 2003 Delaware Tax Institute (Revised February 2004), at 4-5. A discussion of this topic is beyond the scope of this article.

[21] Gain on a liquidating distribution could also arise under Code Sec. 752(b). Under that provision, a constructive distribution of cash arises if a partner is relieved of some of all of his or her share of partnership liabilities. In a typical MAP, there would be little or no liabilities. As such, this provision would not normally serve to trigger gain recognition in the liquidation of a MAP.

[22] The gain or loss would be limited to the amount that would have been specially allocated to the partner. Code Sec. 704(c)(1)(A).

[23] *See* Reg. §1.704-4(d)(2).

[24] The recognized gain is limited to the lesser of (1) the distributee partner's remaining unrecognized pre-contribution gain or (2) the excess of the property's FMV over such partner's outside basis in the partnership. Code Sec. 737(a). The outside basis first must be adjusted for cash or deemed cash distributed. *See* Reg. §1.737-1(b)(3)(i).

[25] Reg. § 1.737-1(c)(1). *See also* note 22, *supra*.

[26] The discussion to this point has purposely assumed that the partnership has made no optional basis adjustment election pursuant to Code Sec. 754. As one commentator notes, if such an election were in effect, "then the step up in the basis of partnership assets will tend to eliminate the precontribution gain that is the precondition to the application of §§704(c) and 737." Mark P. Gergen, *Potential Trap in Liquidating a Family Limited Partnership*, 29th Annual Advanced Estate Planning and Probate Course (June 8–10, 2005), at 1.