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Basis Planning and Anomalies with Partnerships, Grantor Trusts, and Unitary Basis

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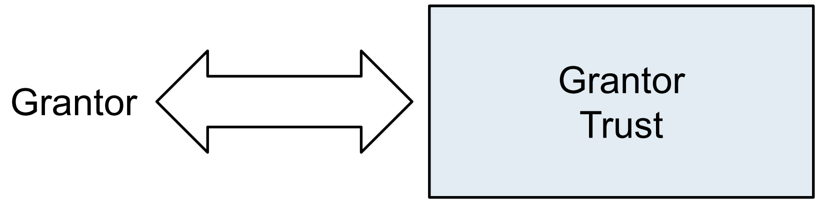
Exploring Ownership, Disregarded Taxpayers, and Unitary Basis

Disregarding Ownership and Taxpayers



__Rothstein__

[§ 671 dictates that, when the grantor is regarded as "owner", the trust's income shall be attributed to him—this and nothing more.]

Rev. Rul. 85-13

[The court's decision in Rothstein, insofar as it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor, is not in accord with the views of the Service.]

Proposed § 1062

[In the case of any **transfer** of property between a trust and the person who is the **deemed owner** of the trust (or portion thereof), such treatment of the **person as the owner** of the trust shall be **disregarded** in determining whether the transfer is a **sale or exchange**]

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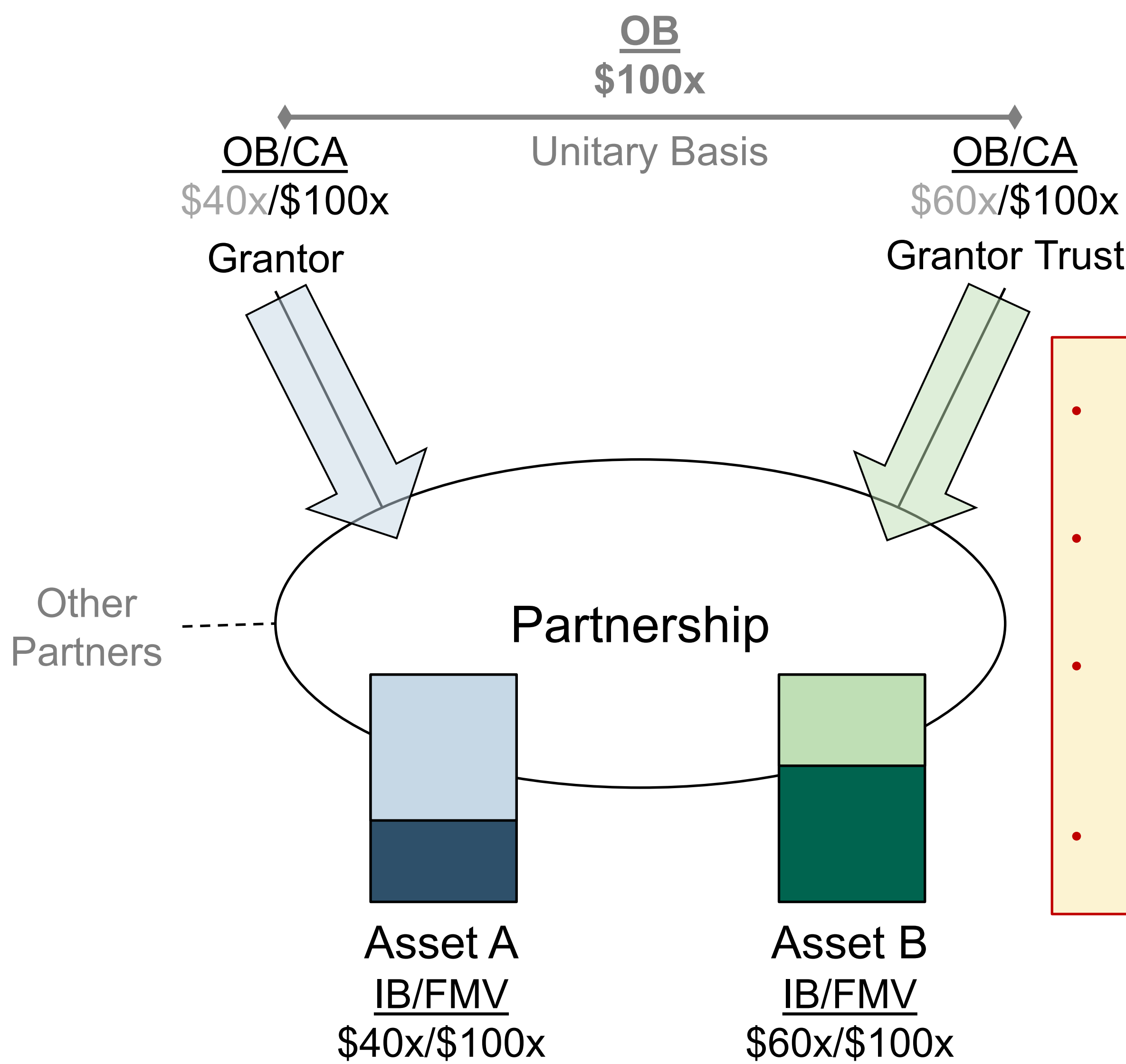
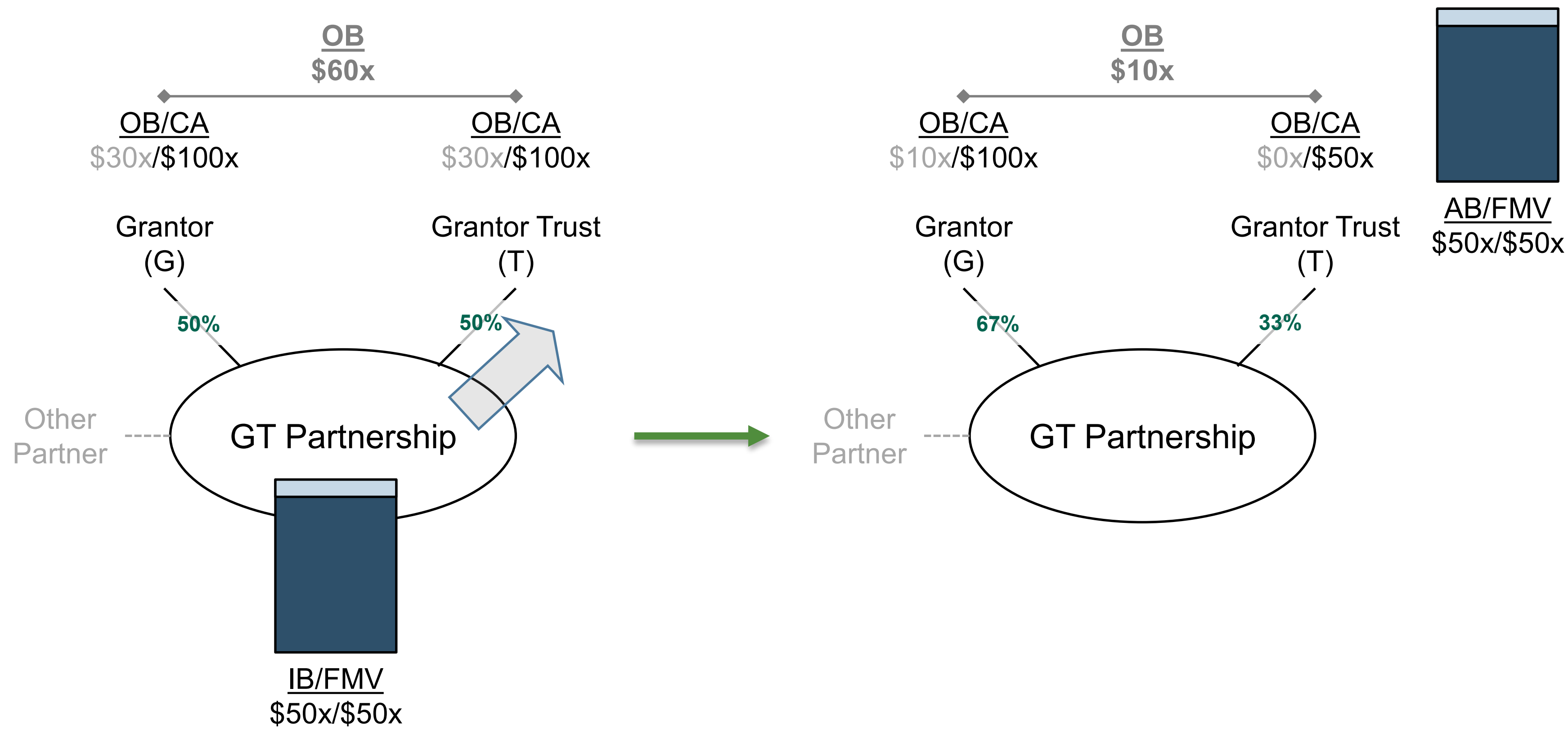
Disregarding Ownership: Unitary Basis Rule



Why is outside basis important?

- Determines amount of **money** that can be distributed without gain
- Partnership **losses** are allowable only to the extent of outside basis
- Determines amount of gain or loss recognized on a taxable **sale** of partnership interest
- Determines **basis** of **distributed** property

Unitary Basis: Moving Basis without a Swap

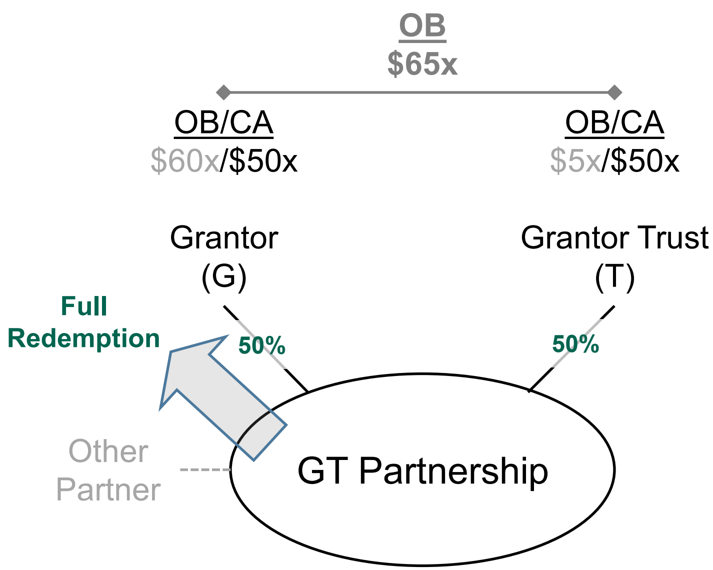


T has increased basis in its assets from $30x to $50x.

Same practical result as a "swap" under § 675(4)(C) power.

Possible workaround if proposed § 1062 (or similar) is enacted.

Unitary Basis: Perplexing Distribution Results



- Current (non-liquidating) distributions can only result in **gain** (not loss) and distributed property will have a resulting basis **equal to or less** than its inside basis.
- Liquidating distributions can result in **gain and loss** and distributed property can have a resulting basis that is **equal to, less than, or more** than its inside basis.

1. GT distributes $50x cash to G

No -$10x loss to G

T's Resulting OB/CA:
$15x/$50x

2. GT distributes $30x/$50x property to G

G holds property with $30x basis (not $60x)

T's resulting OB/CA:
$35x/$50x

3. Convert to non-grantor trust and distribute $50x cash

G may result in a loss (-$10x) or
may result in gain (+$17.5x)

Depends on how much unitary basis is allocated between G and T upon conversion.
If G has $60x of OB, then -$10x loss.
If G has $32.5x of OB, then +$17.5x gain.

T's resulting OB/CA can be:
$5x/$50x
or
$32.5x/$50x

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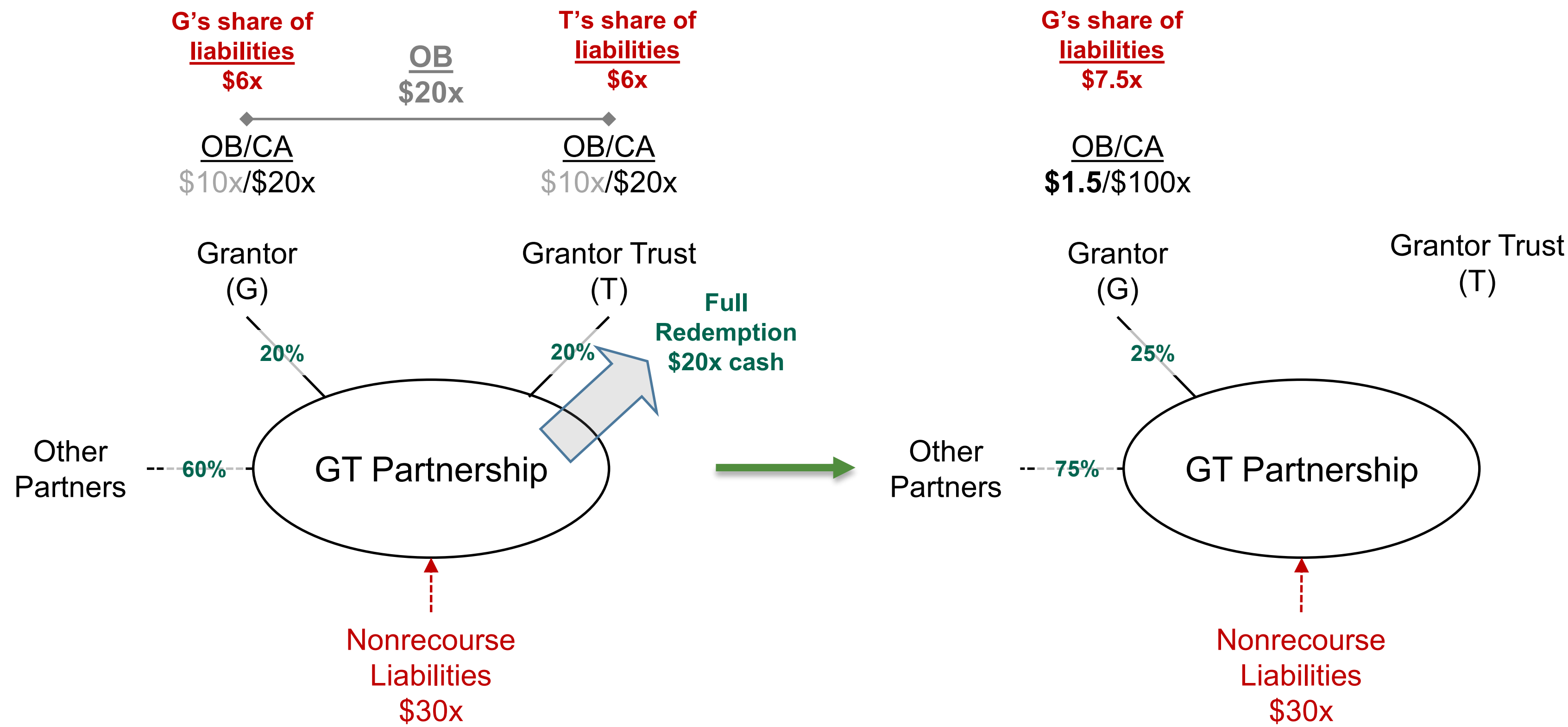
Unitary Basis: Sharing Liabilities



Redemption of T's interest results in -$6x of liability reduction (§ 752(b) deemed distribution).

Total distribution of $26x: $20x cash plus $6x deemed distribution.

Unitary basis of $20x results in $6x of gain (not $16x of gain).

G's share of liabilities increases proportionately ($1.5x increase in outside basis).

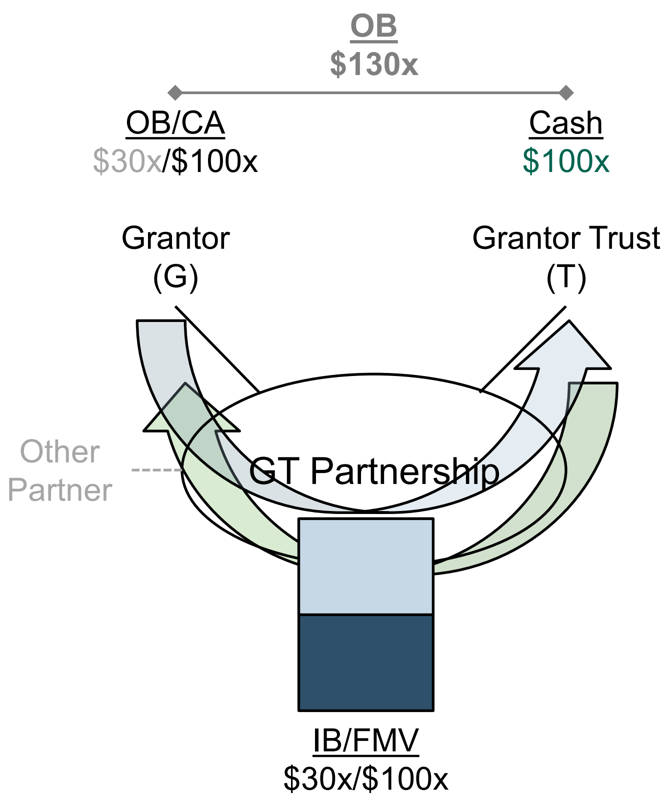
Rev. Rul. 85-13 and the Disguised Sale Trap

<u>Elements of a "Disguised Sale" (Facts and Circumstances)</u>:

1. Contribution of money or property by partner to partnership
2. Related transfer of money or property by the partnership to the partner
3. When viewed together, properly characterized as a sale or exchange

<u>3 Types of Disguised Sales</u>:
Sale by partner to partnership
Sale by partnership to partner
Sale of partnership interest between partners

2-Year Rebuttable Presumption



<u>Rev. Rul. 85-13</u>
Does NOT shield disguised sale treatment if sale by partner (other than in capacity as partner) to partnership or partnership to partner

NO disguised sale if treated as sale of partnership interest between partners

<u>Gain could be avoided today if</u>:
G and T swapped property for cash first and then contributed to GT Partnership

Entity was a disregarded entity (redeem the "other partner")

Wait at least 2 years

<u>Proposed § 1062</u>
Disguised sale of partnership interest between G and T would be taxable gain

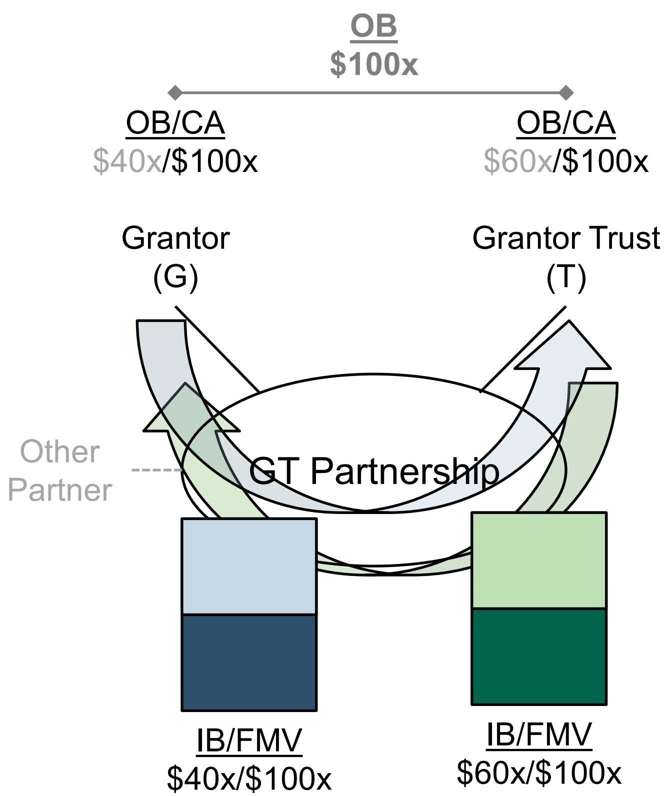
Swap and disregarded entity transfers would be taxable

Rev. Rul. 85-13 and Mixing Bowl Rules

2 Forms of "Mixing Bowl" Transactions:
1. Contributed property distributed to another partner, **OR**
2. Other property distributed to contributing partner

Distribution back to contributing partner is not a "mixing bowl" transaction.

7-Year Rule



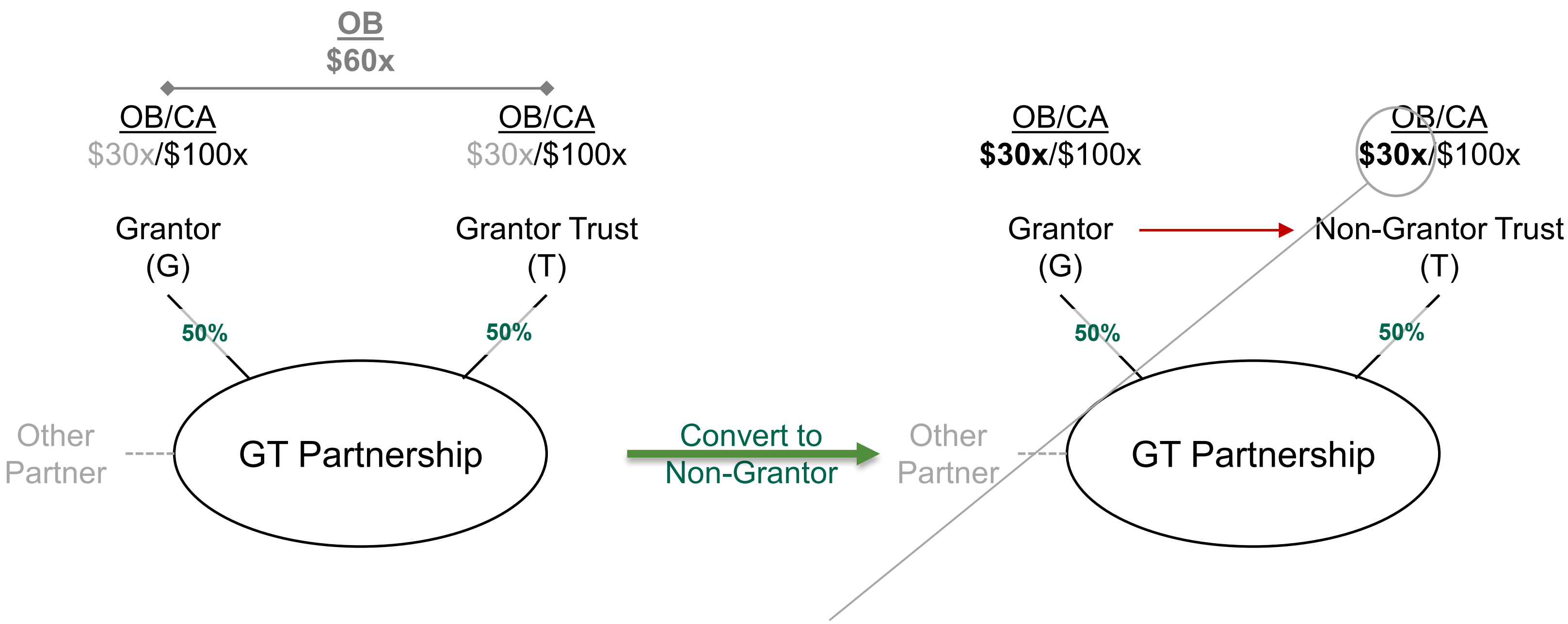
Rev. Rul. 85-13
No mixing bowl problem because G and T are both considered the contributing partner.

Proposed § 1062
No mixing bowl problem either.

Gain under § 704(c)(1)(B) and § 737 is allocation of gain to partner who contributed appreciated property (not a transaction between partners).

Unitary Basis: Conversion from Grantor to Non-Grantor

<u>Conversion from Grantor to Non-Grantor</u>
Deemed transfer from Grantor to the Trust
(Rev. Rul. 77-402, Treas. Reg. § 1.1001-2(a)(4)(i) & (iv))



Requires an allocation of the unitary basis to the deemed transfer to the trust.

Be careful of gain due to debt in excess of basis (partnership interest collateralizes a debt).

This assumes taxpayer's entire interest carries the same valuation discount as the transferred interest.

Unitary Basis: Conversion from Grantor to Non-Grantor

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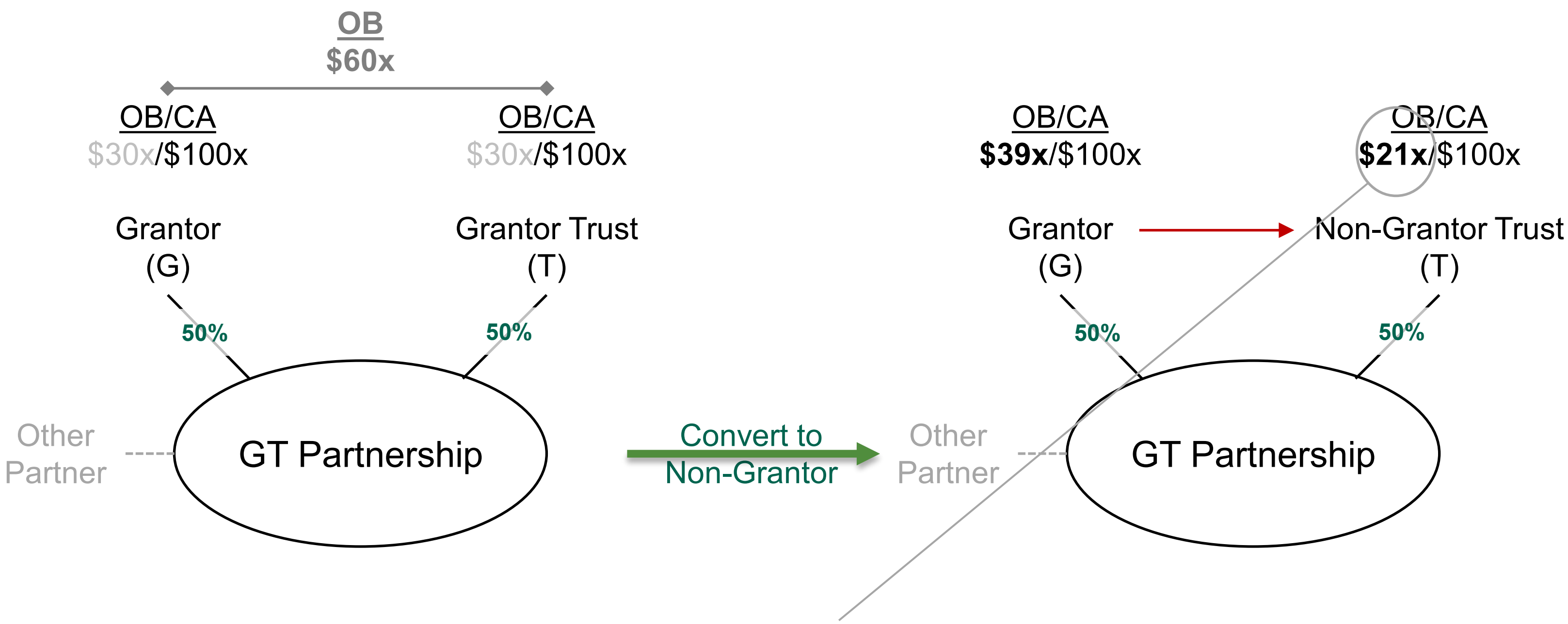
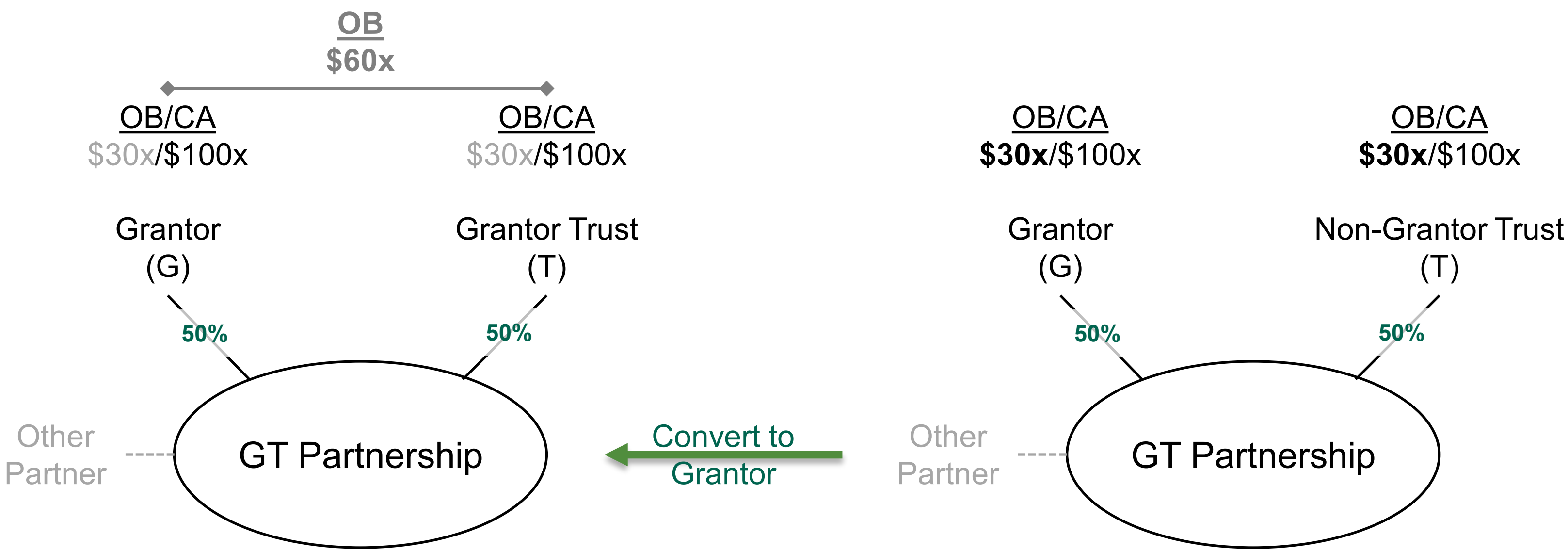


If taxpayer's entire interest has no valuation discount (liquidation value) but the transferred interest carries a 30% discount, then less outside basis is allocated to the trust.

"[T]he basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest." Rev. Rul. 84-53, 1984-1 C.B. 159.

Unitary Basis: Conversion from Non-Grantor to Grantor

Conversion Non-Grantor to Grantor Trust:
Not a transfer for income tax purposes
(CCA 200923024, PLR 201730018)



Sort of Like a "Grantor Trust"… 2 Rulings, 2 Different Results?

CREATING "PSEUDO" GRANTOR TRUST

§ 678(a)(1): Power to vest income or corpus (BDOT)
§ 678(a)(2): Released power with retained powers under §§ 671-677 (BDIT)
§ 678(b): Provided original grantor is not considered owner under §§ 671-677

PLR 201633021

- Trust 1
  - Grantor deceased
  - F/B/O children, spouse, and issue
  - Trustee proposes to transfer assets to Trust 2
- Trust 2
  - F/B/O children, spouse, and issue
  - Trust 1 retains sole power to revest net income of Trust 2
  - Lapses on the last day of the calendar year
  - "Net income" includes income under § 643(b) & capital gain

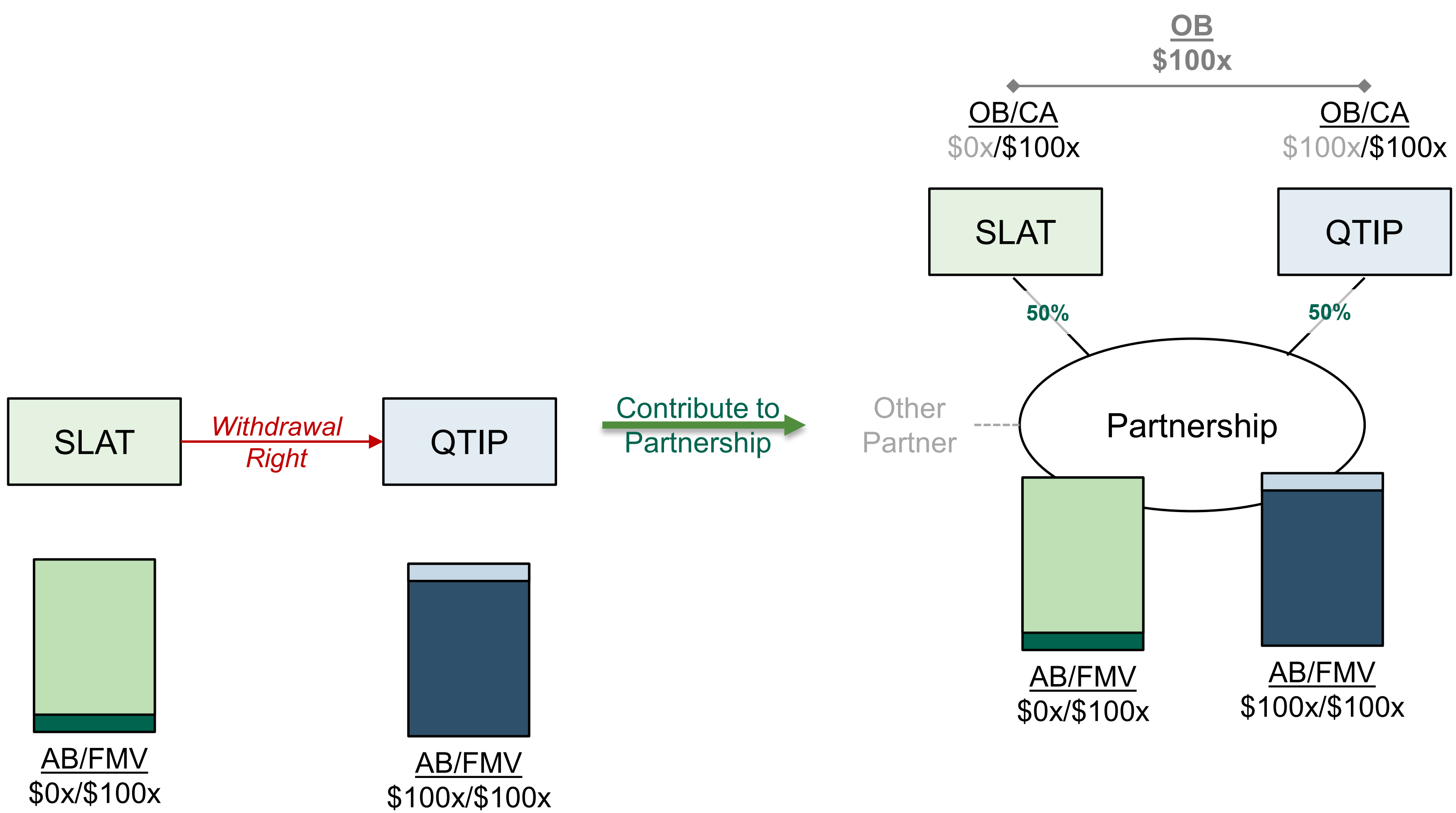
Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2.

PLR 202022002

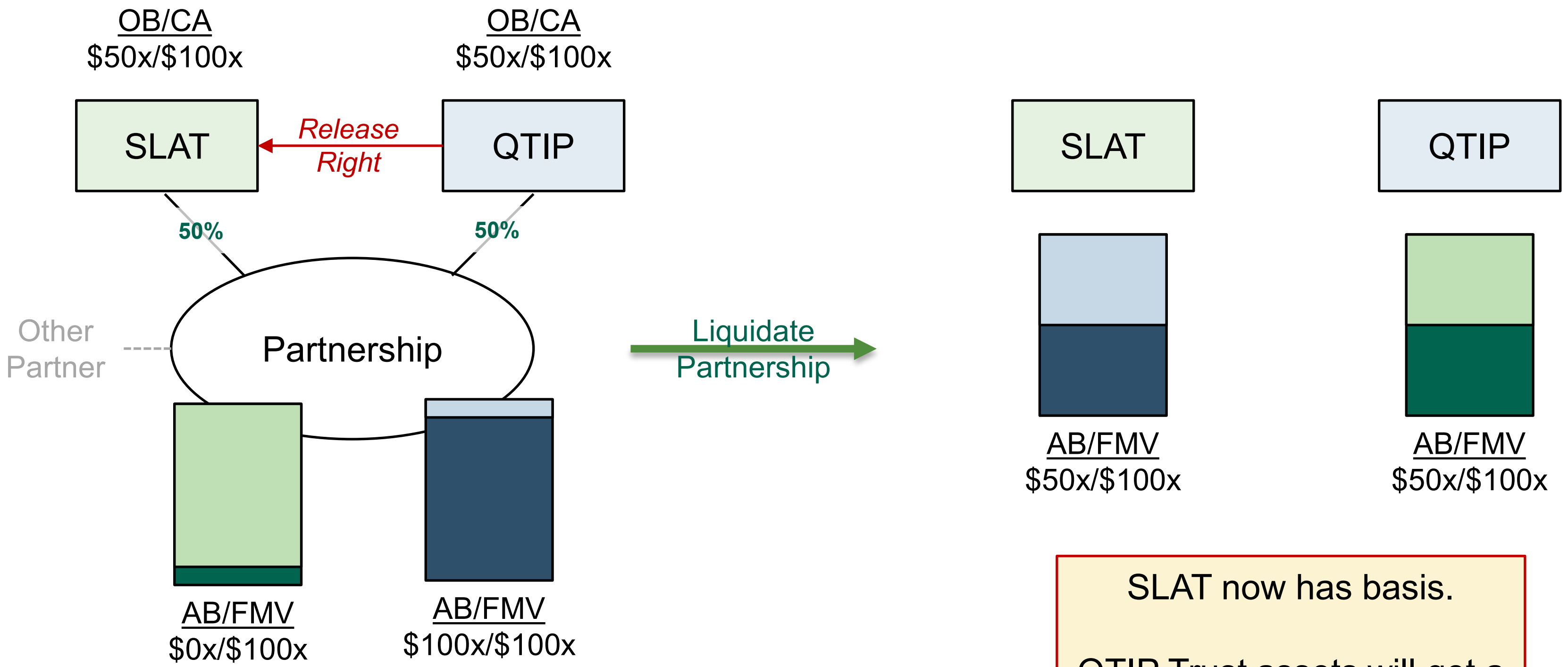
- Trust 1
  - Prohibited distribution of "Shares" (family company)
  - Contributed Shares to LLC
  - LLC interests transferred to Subtrust F/B/O beneficiary A
  - A exercised withdrawal right of all assets of Subtrust (other than LLC interests, which may not be distributed)
  - Subtrust agrees to sell LLC interests to Trust 2 for cash and promissory note
  - A has withdrawal right over cash and promissory note in Subtrust
- Trust 2
  - Grantor trust of A

[B]ecause A has a power exercisable by herself to vest the proceeds of Subtrust's LLC interest in herself and that those proceeds are Subtrust's only asset, A will be treated as the owner of Subtrust under § 678. Consequently, the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A.

Sharing Basis Between Non-Grantor Trusts



Sharing Basis Between Non-Grantor Trusts

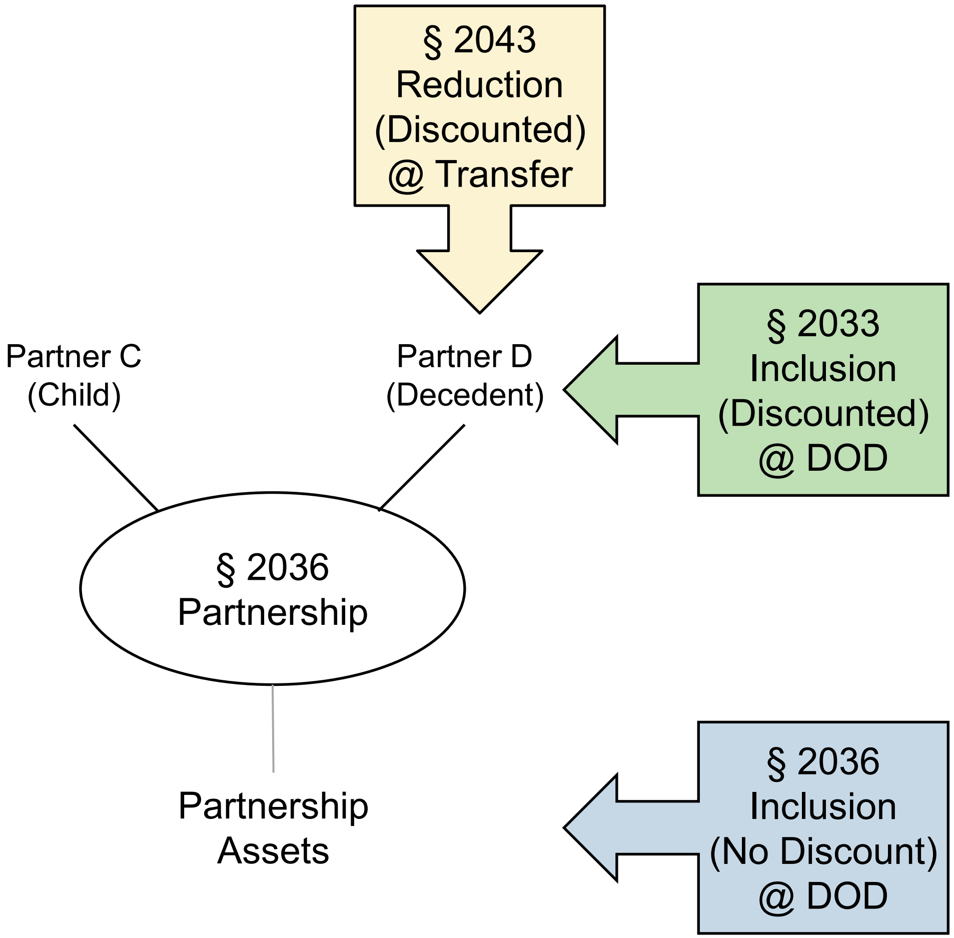


SLAT now has basis.

QTIP Trust assets will get a basis adjustment when spouse passes away

Section 2036 and The Inside/Outside Basis Conundrum

Section 2036: Inside/Outside Basis Conundrum



<u>Estate of Powell/Estate of Moore</u>

$$\mathbf{V_{included} = C_d + FMV_d - C_t}$$

$V_{included}$ = value that must be added to the gross estate

C_d = date-of-death value of the consideration received by the decedent from the transaction that remains in his estate under section 2033

FMV_d = fair market value at date of death of property transferred by the decedent whose value is included in the gross estate under section 2036

C_t = consideration received by the decedent at the time of the transfer, which has to be subtracted under section 2043(a)

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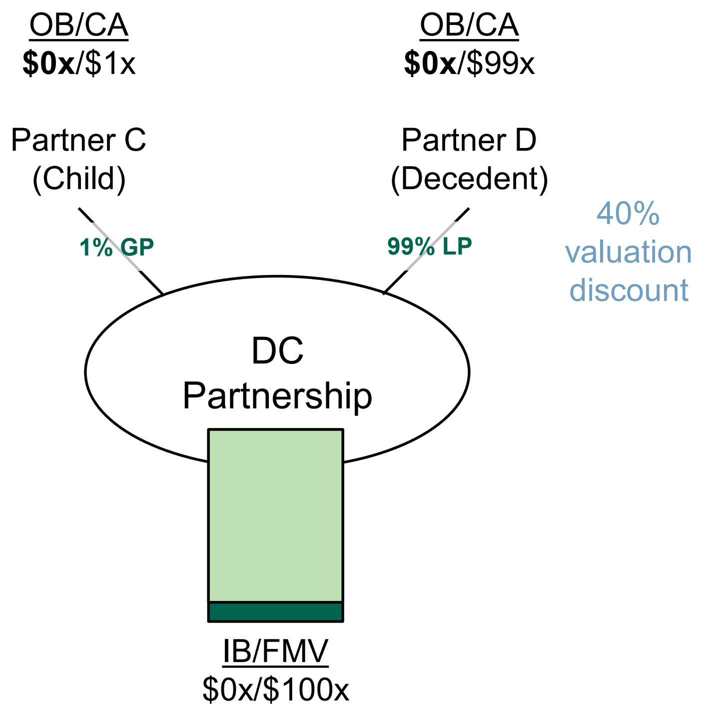
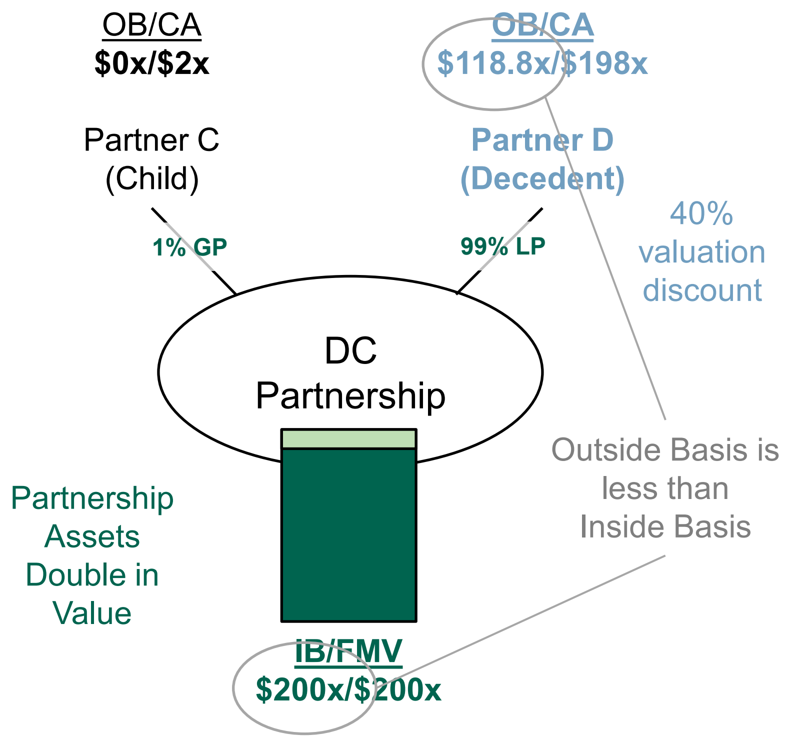
Section 2036: Inside/Outside Basis Conundrum

<u>Example</u>: *D and D's child, C, create DC Partnership. D and C contribute assets with $0x adjusted basis and with a fair market value of $99x and $1x, respectively, in exchange for a 99% LP interest and 1% GP interest. At the time of the contribution, the 99% LP interest is subject to a 40% valuation discount.*



Section 2036: Inside/Outside Basis Conundrum

<u>Scenario 1</u>: Prior to any transfers by D, D passes away and the assets of the DC partnership have doubled in value ($200x). D continued to own the 99% LP interest, subject to a 40% valuation discount. It is determined that the assets of DC Partnership are subject to inclusion under § 2036.



§ 754 election would cause a "step-down" in Inside Basis under § 743(b) to $118.8x with respect to D

<u>Net Inclusion Amount</u>

§ 2033
(99% * $200x * 60%)
99% LP @ 40% Discount = $118.8x

PLUS
§ 2036
Partnership Assets = $200x

LESS
§ 2043
(99% * $100x * 60%)
<u>99% LP @ 40% Discount at "Transfer" = $59.4x</u>
$259.4x

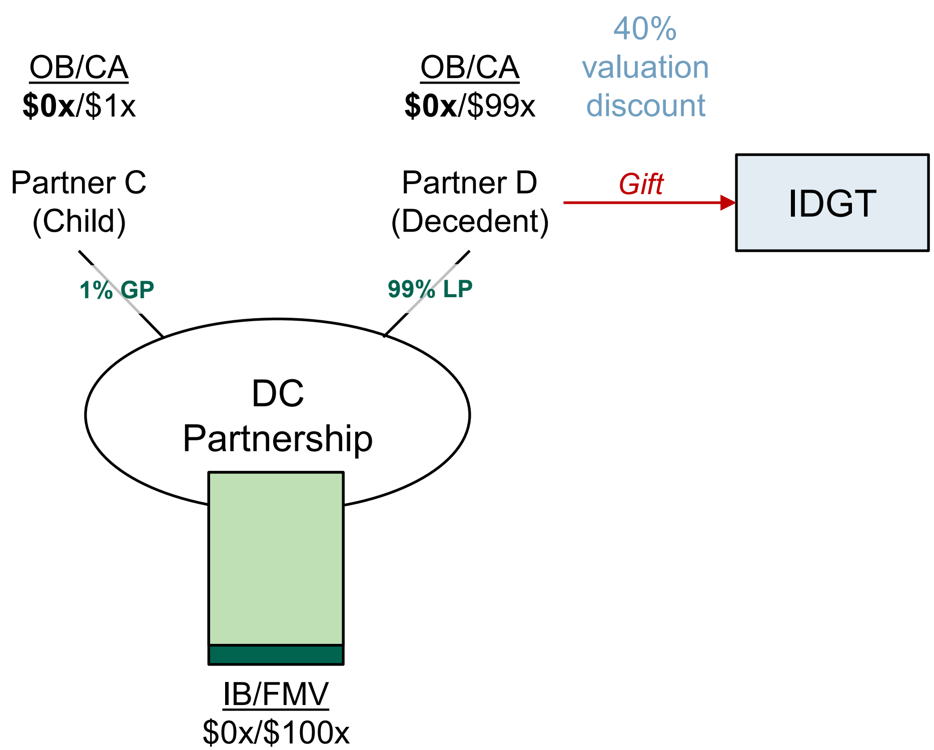
<u>Resulting Basis (Assuming No § 754 Election)</u>

§ 1014(b)(9)
Inside Basis of DC Partnership = $200x

§ 1014(b)(1)
Outside Basis of D = $118.8x

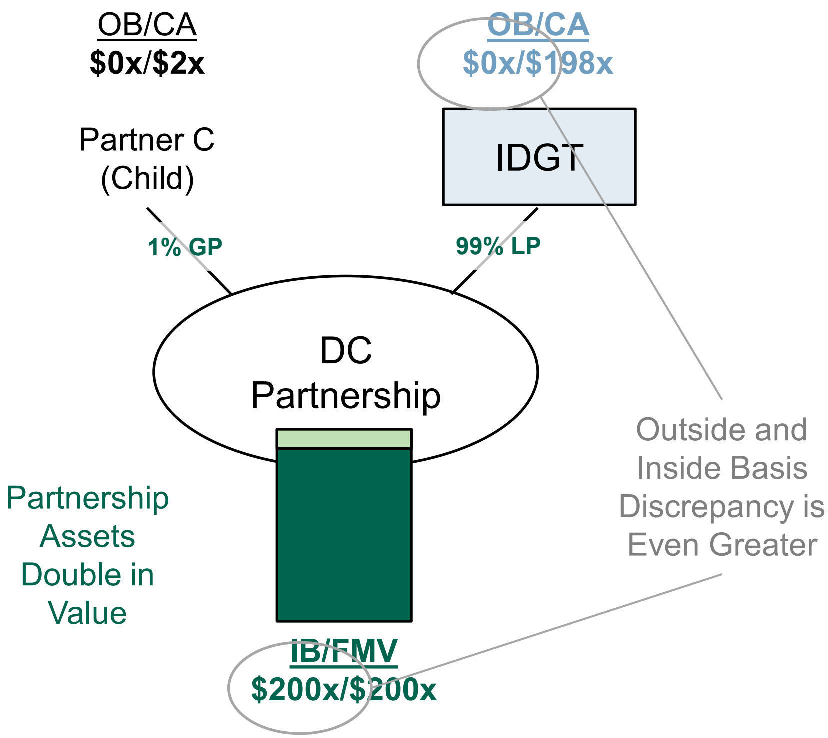
Section 2036: Inside/Outside Basis Conundrum

Scenario 2: After the creation of DC Partnership, D gifts the 99% LP to an IDGT, subject to a 40% valuation discount.



Section 2036: Inside/Outside Basis Conundrum

<u>Scenario 2</u>: D passes away and the assets of the DC partnership have double in value ($200x). It is determined that the assets of DC Partnership are subject to inclusion under § 2036. The 99% LP interest of the IDGT is not included in the gross estate of D.



<u>Net Inclusion Amount</u>

§ 2033
$0x

PLUS
§ 2036
Partnership Assets = $200x

LESS
§ 2043
(99% * $100x * 60%)
<u>99% LP @ 40% Discount at "Transfer" = $59.4x</u>
$140.6x

<u>Resulting Basis (Assuming No § 754 Election)</u>

§ 1014(b)(9)
Inside Basis of DC Partnership = $200x

§ 1015
Outside Basis of IDGT = $0x

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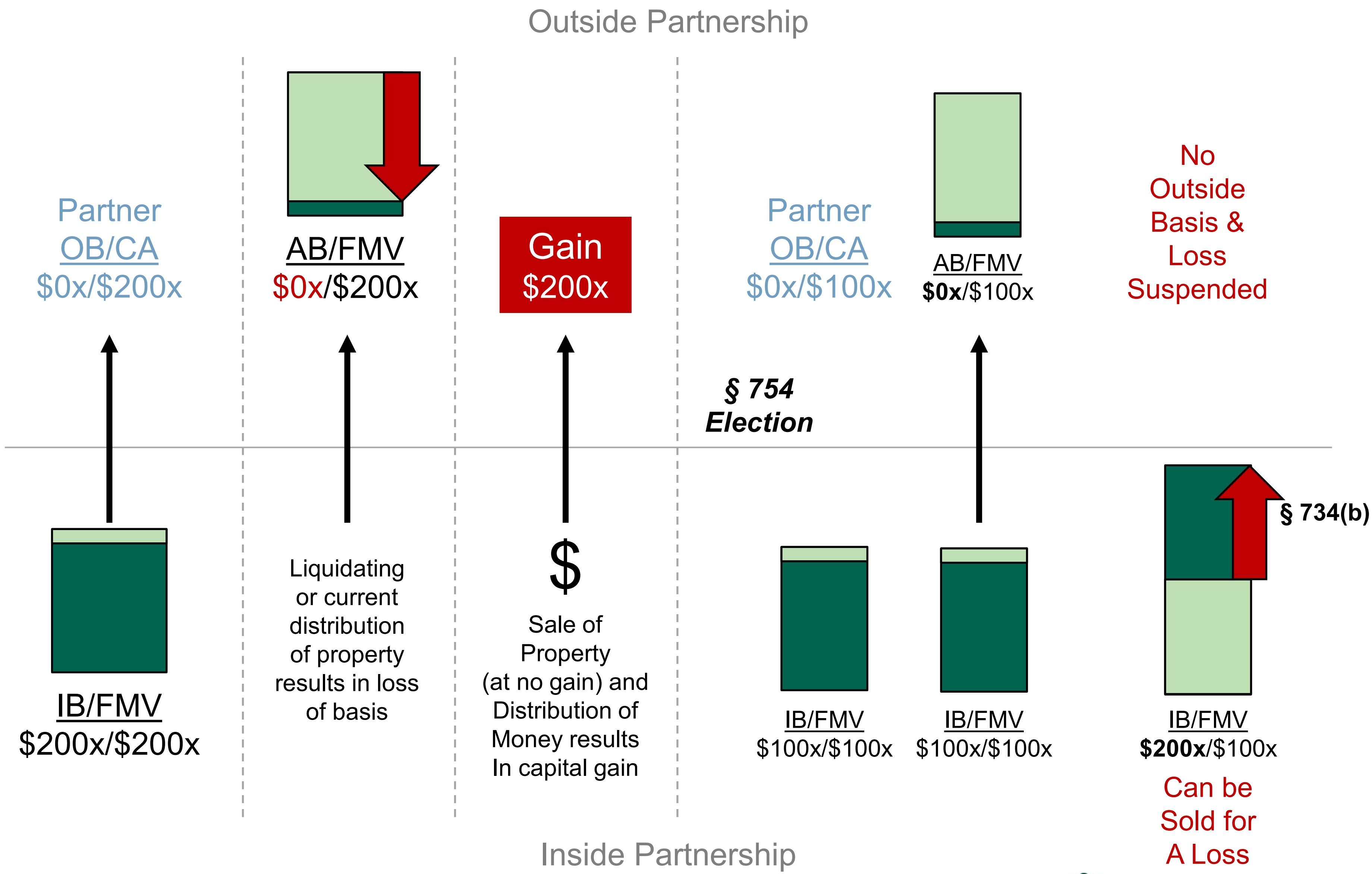
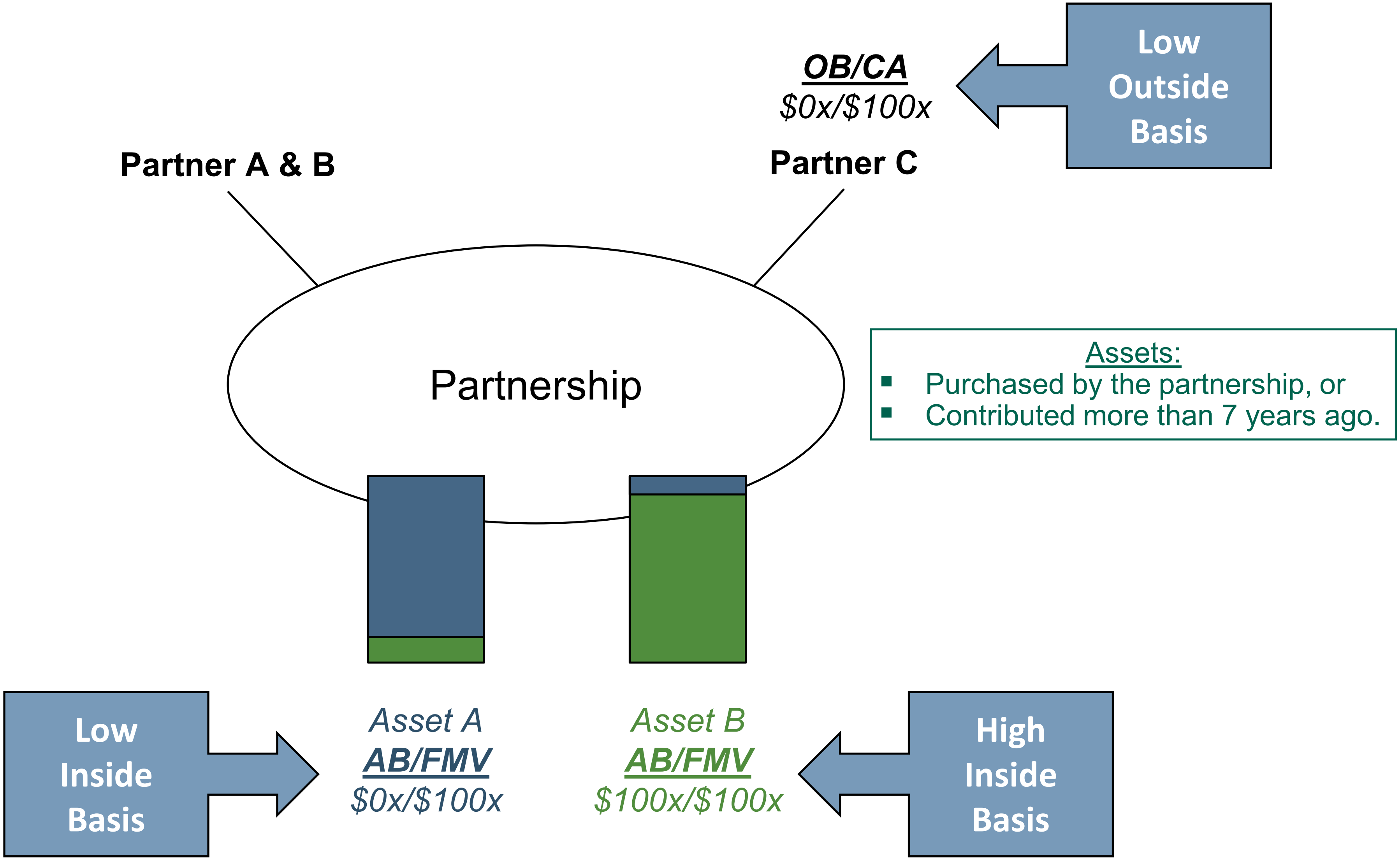
Outside Inside Basis Discrepancy Is Not Easily Cured

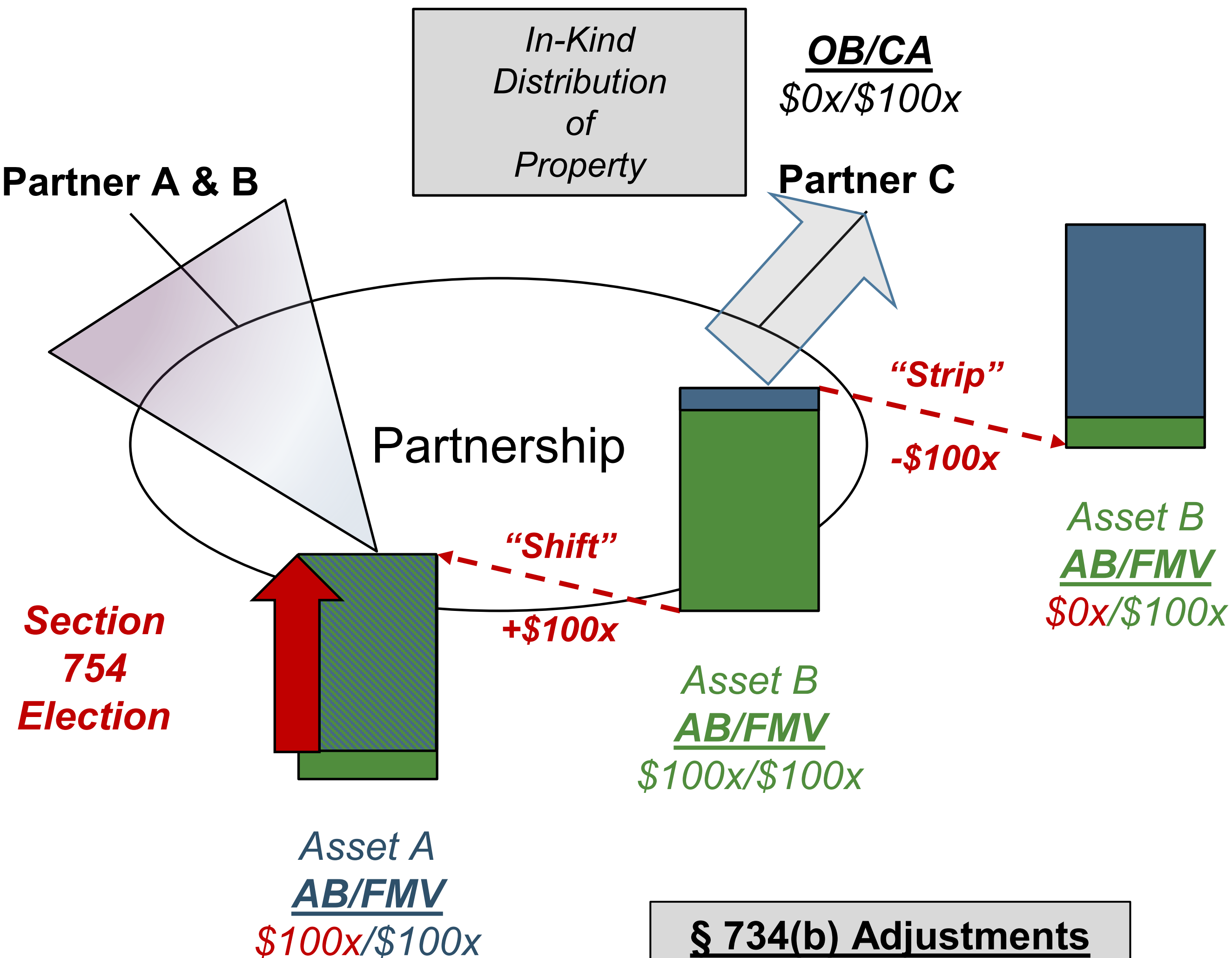


The Basics of Basis Stripping, Shifting, and Swapping

The Basic Elements



“Strip” Basis with Distribution & “Shift” with Election



§ 734(b) Adjustments
To “partnership property”

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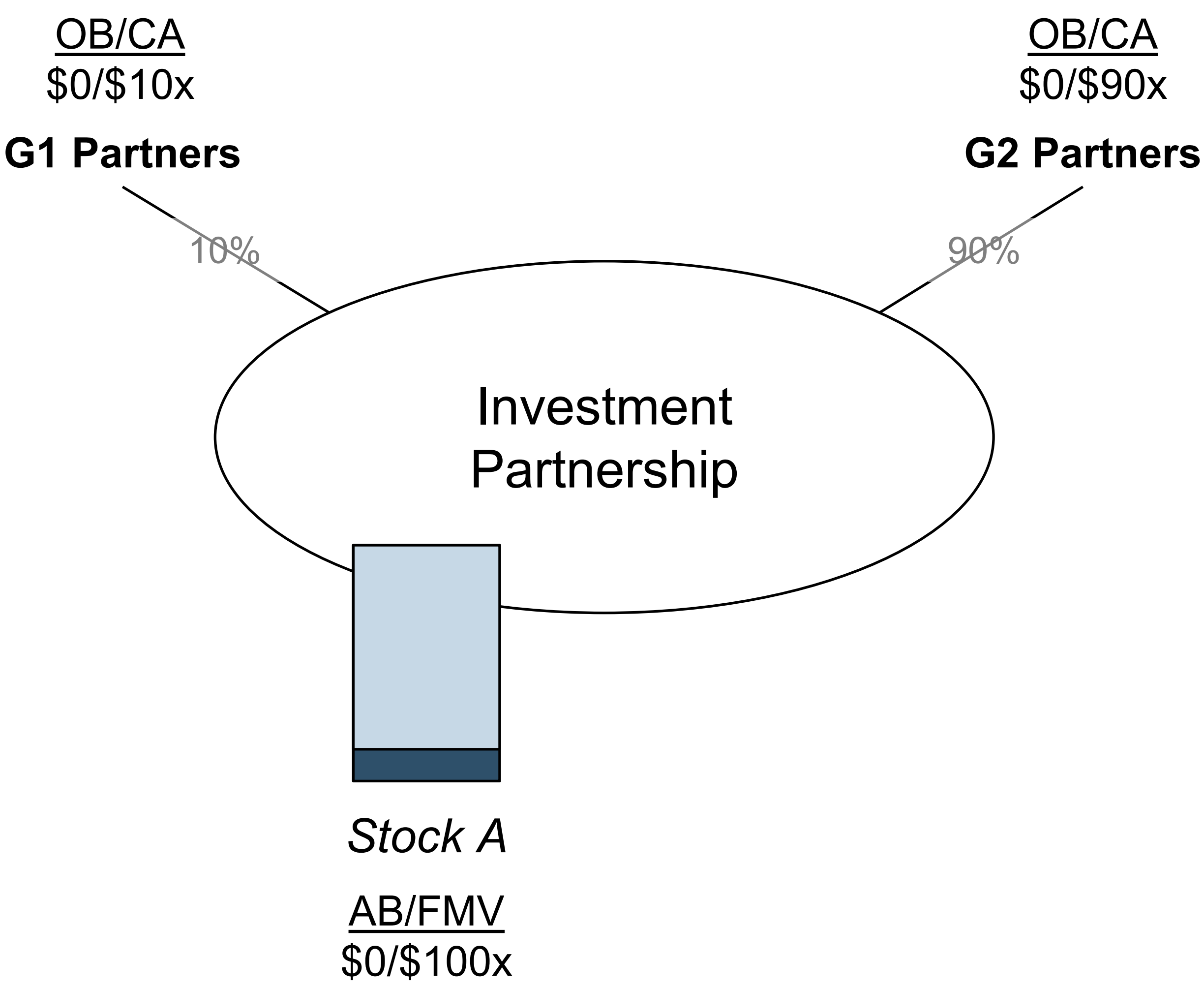
Creating, Stripping, and Shifting Basis (Even with Marketable Securities)

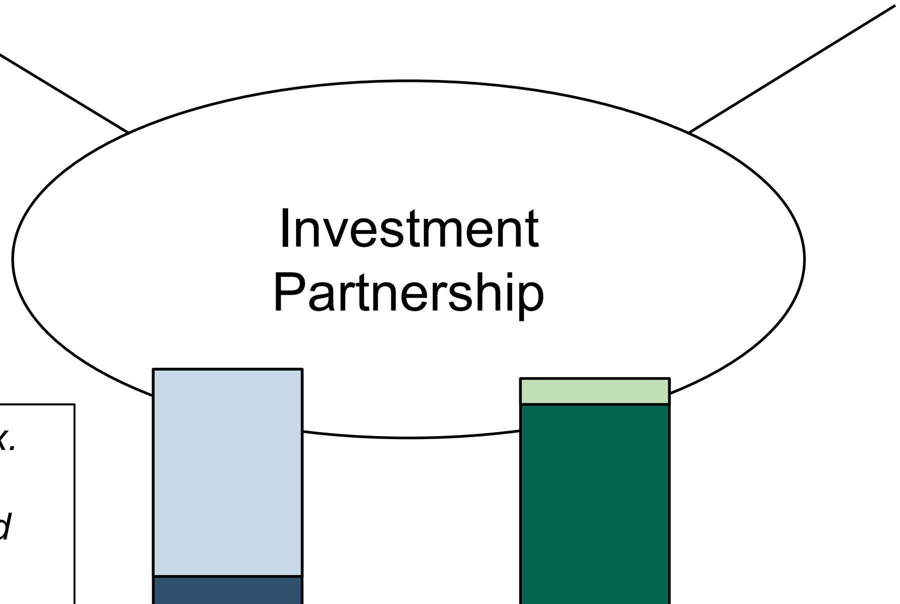
Debt to Exchange Concentrated for Diversified Position



Debt to Exchange Concentrated for Diversified Position

OB/CA
$90x/$10x
G1 Partners

OB/CA
$0/$90x
G2 Partners



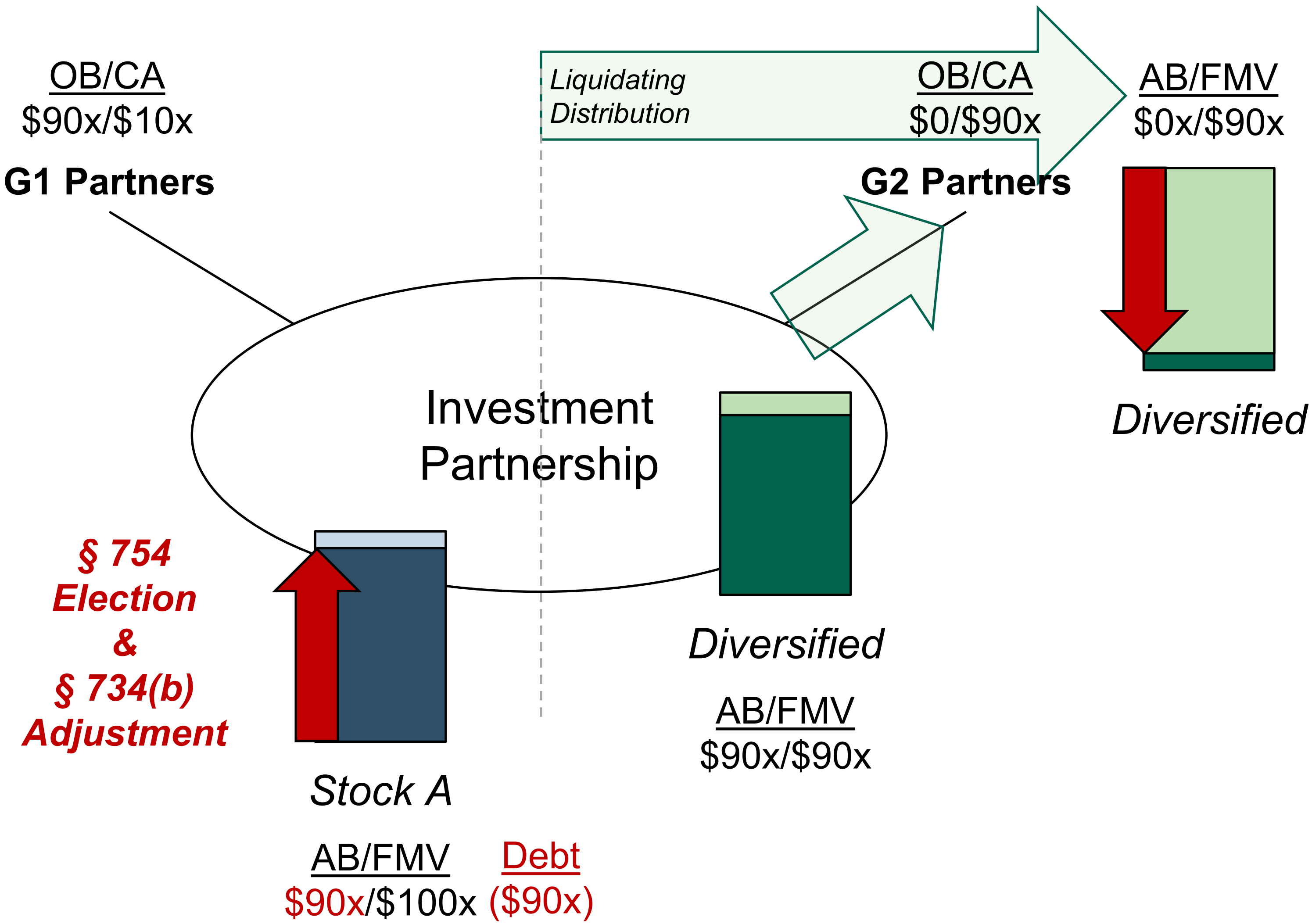
Stock A
AB/FMV
$0/$100x

Debt
($90x)

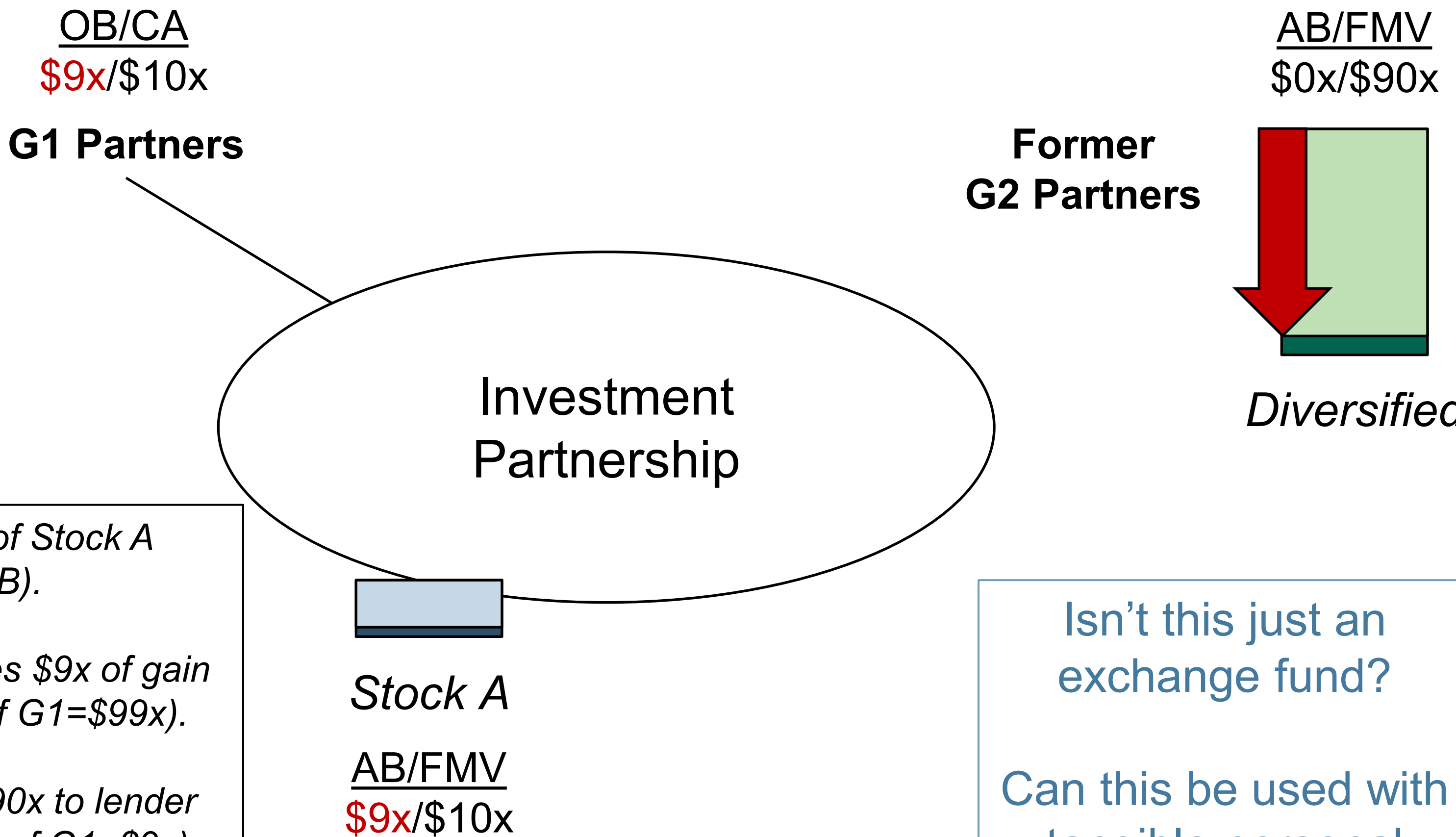
Diversified
AB/FMV
$90x/$90x

1. *Partnership borrows $90x.*
2. *Invests $90x in diversified portfolio.*
3. *G1 solely responsible for partnership liabilities.*

Debt to Exchange Concentrated for Diversified Position



Debt to Exchange Concentrated for Diversified Position



1. *Sells 90x of Stock A ($81x of AB).*
2. *Recognizes $9x of gain (+9x OB of G1=$99x).*
3. *Repays $90x to lender (-$90x OB of G1=$9x).*

Isn't this just an exchange fund?

Can this be used with tangible personal property in lieu of a "like-kind" exchange?

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