Death of a Partner and §754 Elections: Income Tax Traps

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This article discusses the adverse income tax consequences that can inadvertently occur upon the death of a partner in a family limited partnership. If aware of these traps, the careful estate planning advisor can take preventive action to avoid their negative income tax results. Two of these traps involve the voluntary use, or misuse, of the §754 election. A further trap was added by the American Jobs Creation Act of 2004 with the mandatory use of the §§743 and 734 adjustments. After describing these traps, the authors suggest preventive actions to avoid them.

Despite continued challenges by the Internal Revenue Service ("IRS") and recent Tax Court and circuit court rulings, family limited partnerships ("FLPs") remain an important part of estate planning. However, the estate tax savings achieved by an FLP structure can be significantly reduced by the unique income tax rules applicable only to partnerships. The improper use of the special basis elections under §754 and the mandatory basis adjustment provisions recently adopted as part of the American Jobs Creation Act of 2004 (the "Act"), can undercut the estate tax planning benefits of an FLP structure. As discussed below, the impact of a voluntary or a mandatory §754 election must be carefully considered, not only when implementing an FLP planning strategy, but when a partner dies.

BACKGROUND

While FLPs have multiple planning purposes (e.g., creditor and asset protection; consolidation of family wealth; diversification of risk; pooling of investment opportunities; vehicle for lifetime gifting to desired beneficiaries), from an estate tax perspective, the FLP allows the transfer of wealth subject to gift, estate, and generation skipping transfer taxes for a discounted or leveraged value. In the typical situation, the client contributes assets to the FLP in exchange for limited partnership interests. The client then makes gifts of limited partnership interests (perhaps directly to descendants or to trusts for their benefit), which, after applying all available valuation discounts (lack of control and lack of marketability), have a fair market value less than the proportionate value of the underlying assets owned by the FLP.

After the lifetime gifting has occurred, the desired objective is that the assets within the FLP have a higher fair market value than the collective value of all of the interests in the FLP. Furthermore, if there have been lifetime taxable sales, or transfers that occur upon the death of a partner, then the FLP's adjusted tax basis in its assets (the "inside tax
basis") may be different than the collective fair market value of the FLP interests (the "outside tax basis").

The FLP takes a carryover basis for any assets contributed to it by a partner. In other words, the basis of each underlying asset is the same to the FLP as it was to the partner who contributed the asset. And, the partner's basis in the contributed assets is also that partner's basis in the partnership interest received. Therefore, all gratuitous lifetime transfers of partnership interests continue to apply a carryover basis to a transferee's outside tax basis. However, carryover basis does not apply upon the death of a partner (or a sale of a partnership interest). Instead, the value of a decedent's partnership interest as of the decedent's date of death (the value reported on the estate tax return) determines the basis that the "transferee partner" will take as its "outside tax basis" in the partnership interest received by reason of the death of the deceased partner. And, without a §754 election in place for the partnership tax year in which a partner dies, a partner's death does not affect the partnership's "inside basis" in its underlying assets. Without any special adjustments to the "inside basis," a subsequent sale of assets by the partnership will not take into account the tax-free step up in basis or tax-free step down in basis for the partnership interest that was included in the deceased partner's estate.

Section 754 addresses this "basis mismatch" by allowing the partnership to elect to make a special basis adjustment to the basis of partnership assets, and thereby account for the difference between the outside tax basis of the partnership interest as held by the transferee partner and the decedent's tax basis in the partnership interest before death (the "§754 election").

In the case of a transfer of a partnership interest by sale or exchange and in the case of a transfer by reason of death of a partner, the adjustment is made under §743.

It is an almost automatic reflex for accountants and estate planning lawyers to recommend that the partnership have a §754 election in place for the partnership's taxable year in which a partner dies. The perception is that the §754 election is needed to pass the tax-free step up in basis obtained upon the death of a partner for the transferee partner's partnership interest (outside basis) inside to the partnership's assets (inside basis). The tendency to make a §754 election upon the death of a partner when the partnership owns appreciated assets does not take into account the impact valuation discounts can have, as the following example clearly illustrates.

Example (1)

Senior contributed a diversified portfolio of marketable securities with a fair market value of $13,333,333 and a basis of $12,000,000 to a FLP in exchange for a limited partnership interest. An S Corporation owned by a non-grantor trust created by Senior is the general partner, entitled to 1% of profits as a service partner who has not made any capital contribution. Senior owns a 99% profits interest as a limited partner ("LP interest").

The LP interests are subject to a 25% valuation discount, giving them an approximate fair market value of $10,000,000. Senior sells the LP interest to a grantor trust in exchange for a 20-year, interest-only promissory note in the principal amount of $10,000,000. Senior dies one year later, and the fair market value of the FLP assets has increased to $14,500,000.

Upon Senior's death (not immediately before and not immediately after, but simultaneous with the moment of death) the purchasing trust becomes a non-grantor trust. For Federal
income tax purposes the non-grantor trust has acquired the LP interest by purchase as of the moment of Senior's death. The trust's basis in the LP interest is $10,000,000 (the outstanding principal amount of the promissory note). Its share of the adjusted inside basis of the FLP assets is $12,000,000. Under these circumstances, if the FLP filed a §754 election for the year of Senior's death, then, under §743, the FLP would have a negative or downward basis adjustment of its assets of $2,000,000 even though the assets owned by the partnership have appreciated in value. Thus, in this case, the FLP should refrain from filing a §754 election.

Because accountants and lawyers may inadvertently overlook the impact of valuation discounts on FLP interests, they may recommend that the partnership file a §754 election as a matter of course, in order to obtain the perceived “step up” of the inside basis of the partnership's assets (e.g., they assume that since the partnership assets have appreciated, the deceased partner's partnership interest will also have increased in value, when the reality is that, if the valuation discounts are successful, the includible partnership interest has declined in value). As illustrated above, where discounts cause the inside basis to exceed a transferee partner's outside basis, this almost automatic filing of a §754 election can have unintended and adverse future income tax consequences upon a later sale of partnership property. Therefore, the partnership should not file a §754 election for the year of death in this situation.

Yet, remember that once a §754 election is made by a partnership, it remains in effect for the entire term of the partnership and applies “to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent partnership taxable years.” The partnership may only revoke the election with the consent of the District Director of the district in which the partnership files its returns. The partnership must show reasonable grounds for requesting the revocation. The Regulations specify that the following may be acceptable reasons for requesting the change:

1. A change in the nature of the partnership business;
2. A substantial increase in the assets (not values) of the partnership;
3. A change in the character of partnership assets; and
4. An increased frequency of retirements or shifts of partnership interests, thereby increasing the administrative burden of the election.

The IRS generally will not provide consent to a revocation solely because the value of the partnership assets may have declined in the years following any prior §754 election. The binding §754 election could be a potential time bomb as it relates to multiple transfers of partnership interests. For example, while a §754 election may have been tax-efficient at the death of one partner (a senior family member), its application when a second partner (a junior family member) dies or sells his or her partnership interest may have adverse tax consequences to the transferee partner. Accordingly, where partnerships have a prior §754 election still in effect that, upon the death of a current partner or other sale or exchange of such partner's partnership interest, would cause a negative basis adjustment, the partnership should consider seeking to revoke its prior election before the occurrence of such events, particularly if any of the above acceptable reasons for revocation exists.

In the alternative, since it is highly unlikely that the IRS will grant a revocation of the
partnership's prior §754 election, practitioners should consider the possibility of using the technical termination rules under §708(b) to accomplish the same objective. For example, the use of a taxable intra-family sale of greater than 50% of the total interests in partnership capital and profits within any 12-month period can cause a termination of the current partnership and the creation of a new partnership for Federal income tax purposes. The new partnership will not be bound by the prior §754 election. The preamble to the proposed §708(b)(1)(B) regulations, which were finalized in May 1997, supports this statement.

**MANDATORY BASIS ADJUSTMENT UNDER THE ACT**

The discussion above focused on a FLP's flexibility in making a §754 election in order to adapt to its particular financial circumstances at the time of a transfer of a FLP interest. However, with the passage of the American Jobs Creation Act, Congress has removed some of this flexibility by making certain basis adjustments under §743 mandatory upon the transfer of partnership interests.

As discussed above, before the Act, a transfer of a partnership interest would only result in an adjustment of the basis of the partnership's property if the partnership made a timely and valid §754 election. Because the election was voluntary, partnerships that held property with a significant loss could refrain from filing a §754 election and later allocate a share of this loss to the transferee partner when the partnership later disposed of or depreciated the partnership's property.

*Example (2)*

X and Y form a partnership. X contributes all of the property with a basis of $10 million, but with a current fair market value of $2 million, to the partnership in exchange for a 99% profits interest in the partnership (Y has a 1% profits interest as service partner, but contributes no capital). X has an adjusted basis in its partnership interest of $10 million. The partnership interest of X is appraised after contribution of the property at $2 million. X sells its partnership interest to Z for its then fair market value of $2 million. The partnership does not make a §754 election after this transfer. X realizes a capital loss of $8 million upon the sale of the partnership interest, and Z takes a basis in the partnership interest of $2 million. The inside basis of the partnership assets is still $10 million. The partnership later borrows $6,000,000, increasing Z's outside basis in his partnership interest by $6 million, to $8 million. The partnership then sells the asset to a third-party buyer for $2 million and must allocate the $8 million loss to Z under §704(c).

In light of these types of transactions, Congress believed that "the partnership rules currently allow for the inappropriate transfer of losses among partners. This has allowed partnerships to be created and used to aid tax-shelter transactions." It passed the mandatory adjustment provisions of the Act in order to restrict a partnership's flexibility specifically with regard to such loss allocations.

As a result, the Act modified §743 to provide that a basis adjustment is mandatory after the transfer (including transfers at death) of a partnership interest, if the partnership has a "substantial built-in loss" after the transfer. For purposes of the Act, a partnership has a substantial built-in loss if, immediately following the transfer, the partnership's adjusted basis in its property exceeds the fair market value of the partnership property by more
than $250,000.26

**Example (3)**

A partnership with no liabilities and no prior §754 election has assets with a fair market value of $4,000,000 and an adjusted basis of $4,300,000. Under §743(d), the partnership has a substantial built-in loss because the adjusted basis of the partnership property exceeds the fair market value of the partnership property by more than $250,000. If A, a partner, sells a 25% partnership interest to B for its agreed upon fair market value of $1,000,000 (with no use of any valuation discounts), then, under §743(b), an adjustment is required to the adjusted basis of the partnership's assets with respect to B.27

Exceptions from the mandatory application of §743(b) apply for "securitization partnerships" 28 and "electing investment partnerships." 29 However, these carve-outs are very limited and do not apply to most partnership structures (specifically, most FLPs).

**APPLICATION TO FLPS**

Although Congress intended this legislation to prevent certain partnership abuses by tax shelter promoters, specifically the "inappropriate" transfers of losses among partners, the mandatory negative basis adjustment provision under §743 will likely significantly impact all partnership planning, including the use of FLPs in an estate planning context. While most FLPs, when created, do not anticipate a significant decline in the value of their underlying assets, given the performance of many investments in today's market, such losses may occur unexpectedly (even if only temporarily). Accordingly, while a FLP may avoid the potential pitfalls of §754 by refraining from filing an undesirable §754 election or revoking a prior election, an FLP may still find itself facing a mandatory negative basis adjustment under §743. Also, remember that new §743 applies to gratuitous transfers by death and not just sales of partnership interests.

**Example (4)**

Senior owns a 99% limited partnership interest in a FLP which owns a diversified portfolio of marketable securities with a basis of $12,000,000, originally valued at $13,333,333 when Senior contributed these assets to the FLP. The fair market value of the FLP assets declined from $13,333,333 to $11,745,000 at the time Senior dies. Remember that the FLP's adjusted basis in its property was $12,000,000, so the FLP's adjusted basis in the property now exceeds the fair market value of such property by $255,000. Accordingly, under § 743, the FLP has a substantial built-in loss in excess of $250,000, and a negative basis adjustment is mandatory.

Even though the FLP does not have a §754 election in place, and is not considering making a §754 election, the provisions of §743 now require that the FLP make a negative adjustment in the transferee partner's share of the tax basis of the FLP assets. So, Senior's beneficiaries (the transferee partners) now have their proportionate share of the tax basis in the underlying asset (i.e., 100%), adjusted down from $12,000,000 to $11,745,000, which, upon a future sale of the partnership property, will increase their gain by an additional $255,000 or reduce their loss by $255,000, as applicable.

Again, knowing the rules, one can easily plan to avoid this negative income tax adjustment under §743. This mandatory treatment only applies upon a transfer of a
partnership interest with a substantial built-in loss. The solution is simple as long as a partner's death is not sudden and unexpected. Just have the FLP sell the loss asset if death of a partner is anticipated. As the following example illustrates, it is important to consider the impact of such sale on the income tax situations of the partners.

**Example (5)**

Using the facts from Example (4) above, if before Senior dies, the FLP sells the loss asset for $11,745,000, it realizes a capital loss of $255,000. Senior's basis in his limited partnership interest is reduced by the $255,000 loss Senior is allowed to report on his individual income tax return.\(^{30}\) So, Senior's basis in his FLP interest (outside basis) is now $11,745,000 ($12,000,000 less $255,000 loss). Thus, Senior has been able to use this valuable tax loss while alive instead of creating a tax-free step-down in basis at death.

**OTHER PLANNING ISSUES**

Both before and after the Act, careful consideration must be given not only as to whether a partnership should make a §754 election, but also as to the timing of when such election should be made. Even though it is recommended that the partnership not make a §754 election for the year of death (because the valuation discount of the interest in the FLP may result in a §743 step down in the inside basis), consideration should be given to making a §754 election in a later tax year, as illustrated in the following example.

**Example (6)**

Senior and Junior are equal partners in a FLP. Junior received her 50% interest by a series of lifetime gifts from Senior. The December 2005 Balance Sheet for the FLP appears as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>$500,000</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>$500,000</td>
<td></td>
</tr>
</tbody>
</table>

Senior dies in 2005, and the value of the 50% FLP interest in Senior's gross estate is determined to be $350,000 (using a 30% valuation discount that is agreed to by the IRS during examination). Since no "substantial built-in loss" exists, there is no mandatory §754 election, and the FLP made no §754 election during the FLPs 2005 tax year (calendar year-end). Thus, Senior's Estate has an outside tax basis in the 50% FLP interest of $350,000 (the value included in Senior's gross estate).

Senior's Estate needs cash to make distributions or to pay administration and tax expenses. So, in early 2006, the FLP sells $500,000 of assets (reporting no gain as a result of the FLP's tax basis -- there being no mandatory or filed §754 election), and distributes all $500,000 to A's Estate. Thus, A's Estate recognizes a $150,000 long-term capital gain.\(^{31}\) However, the FLP should file a §754 election in 2006 because of the distribution of property to Senior's Estate. Pursuant to §734(b)(1)(A), the FLP can now increase the adjusted basis of remaining partnership property by the amount of gain recognized by the distribute partner (the Estate). The positive $150,000 basis adjustment can be utilized or allocated to specific assets in the current year or future years, as provided in §755.\(^{32}\) Note that if the FLP had simply liquidated the partnership, distributing
all of its assets to its partners, the Estate still would have recognized this long-term capital gain, but the ability to use the §754 election to increase the basis of other partnership assets by $150,000 would have been lost as there was no longer a partnership. First, one should consider limiting the distribution to Senior’s Estate to $350,000 so that the cash distribution does not exceed outside basis. And, if it is necessary to distribute more than the $350,000, then the FLP should not be terminated as it can continue in existence and use the §734(b) adjustment to eliminate gain in remaining or future partnership assets.

**RECOMMENDATIONS**

Partnerships with a prior §754 election still in effect should consider filing an application for revocation based on the possibility that the future application of the §754 election would cause a negative adjustment of the inside basis of the partnership assets. Obviously, filing for the revocation of a prior §754 election for future years, before the motivation of the revocation is solely grounded in the possibility of avoiding a potential increased gain, may be easier to accomplish (particularly if one of the acceptable reasons for the request currently exists). Moreover, the revocation of a prior §754 election (if granted) does not prevent the partnership from making a favorable §754 election in a future year when it is desirable (i.e., the death of a partner when the fair market value of the includible partnership interest has increased).

If the FLP assets have over $250,000 of built-in loss and the death of a partner is imminent or expected, the FLP may wish to sell its assets and recognize the loss during the taxpayer’s lifetime (possible offsetting other gains and/or reducing the partner’s current income tax liability). Otherwise, as noted above, the FLP will lose this option at the death of the partner when it is forced to make the mandatory negative basis adjustment under §743. Note, however, that if the FLP attempts to recognize the loss and then reacquire its investments in certain stocks or securities, it should be careful not to run afoul of the “wash sale” rules under §1091.33

Third, if the partnership cannot obtain a revocation of a prior §754 election, consider the use of a taxable intra-family sale and §708(b) to terminate the partnership and create a new partnership that will not be subject to the prior election.

**Footnotes**

* The authors wish to express their gratitude to their associate, Jennifer Smith, Esq., for her valuable contributions to this article.

1 All references to family limited partnerships or FLPs refer as well to limited liability companies or LLCs.

2 Unless otherwise specified, all section references are to the Internal Revenue Code of 1986 or the regulations thereunder, both as amended through the date hereof.


4 The value of the limited partnership interest is less than the capital account assigned to that interest.

5 This is the so-called “loss of value” argument that frequently has been raised by the IRS in recent years. A discussion of this result and the challenges to it are beyond the scope of this article.
§722.

§1015(a).

§§742 and 1014(a). The valuation may be as of the alternate valuation date, if this value is lower. §2032.

§754.

Note that this structure is used for illustrative purposes only, and may have estate tax consequences under §2036. However, an examination of the potential §2036 issues is beyond the scope of this article.

Assume that the valuation discount is valid, was obtained by a qualified appraiser and that the appraised value is not challenged by the IRS or is upheld upon examination and/or audit.


Obviously, the use of valuation discounts to value the includible deceased partner's interest, if successful, will have saved the estate significant estate taxes. This article is not insinuating that those discounts are any less valuable, but rather that the use of these discounts and the customary practice of certain professionals to always file §754 elections at the death of a partner regardless of whether the election is required to be made or not, must be carefully considered and explained to those in a position to decide whether to make the §754 election, as well as those who benefit from the estate.

Regs. §1.754-1(a). As discussed briefly in this article, a taxpayer cannot automatically revoke a §754 election as it is considered a change in method of accounting and requires IRS permission to do so.

Reg. §1.754-1(a) and (c)(1).

Reg. §1.754-1(c)(1).

Id.

§708(b)(1)(B).


The Act also provided for mandatory adjustments for certain partnership distributions under §734(b), although a full discussion of this adjustment is beyond the scope of this article. For a further discussion of these issues see Rosenberg, "ACJA Imposes New Burdens for Partnership Basis Adjustment Under Section 734 and 743," 101 J. of Tax'n 334 (2004); Notice 2005-32, 2005-16 I.R.B. 895, providing interim guidance and procedures for partners and partnerships to comply with the ACJA; Calvin, "Securities Partnerships and Mandatory Basis Adjustments Under the Jobs Act," 34 Daily Tax Report page J-1 (Feb. 22, 2005); Schneider, "New Basis Rules Aim at Transfer and Duplication of Built-in Losses," 83 Taxes 39 (2005); Lipton & Golub, "Dealing with the Service's Interim

22 §743(a).


24 Id.

25 §743(a) as amended by the Act §833(b)(1); §743(b) as amended by the Act §833(b)(2).

26 §743(d)(1) as amended by the Act §833(b)(3).


28 §743(f)(2) as amended by the Act §833(b)(5). Securitization partnerships involve partnerships whose sole business activity is to issue fixed principal securities that are primarily serviced by financial assets that convert into cash within a fixed period.

29 §743(e)(6) as amended by the Act §833(b)(4)(A). Electing investment partnerships are generally securities investing and trading entities formed with cash contributions with a term of 15 years or less.

30 Senior will hopefully have sufficient capital gains to use the capital loss, and if a joint return, they can be carried over by the surviving spouse.

31 Under §1223(11) all property acquired by a Decedent is considered long-term capital gain, regardless of actual holding period.

32 If the partnership cannot use the positive §734(b) adjustment because it has no remaining appreciated assets at that time, §755(b)(2) allows the basis increase to be applied against subsequently acquired property of like character in accordance with the relevant Treasury Regulations.

33 A wash sale will arise if the partnership attempts to replace the investment subject to §1091 within a specified period (i.e., 61 days, beginning 30 days before the sale of property and ending 30 days after the sale). See §1091(a).