POTENTIAL TAX TRAPS IN LIQUIDATING A FAMILY LIMITED PARTNERSHIP

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# TABLE OF CONTENTS

## I. OVERVIEW .................................................. 1

## II. PRO RATA DISTRIBUTIONS ............................................. 1

### A. Section 737 .................................................. 1

#### 1. In general .................................................. 1

#### 2. Transferees inherit precontribution gain ........................................... 2

#### 3. The contributed property exception ........................................... 2

#### 4. Consequence if exception does not apply ........................................... 3

### B. Section 731(c) .................................................. 3

## III. NON PRO RATA DISTRIBUTIONS ........................................... 4

### A. Section 704(c)(1)(b) .................................................. 4

#### 1. Introduction .................................................. 4

#### 2. The sting in a non pro rata distribution ........................................... 5

### B. Section 737 .................................................. 5

#### 1. In general .................................................. 5

#### 2. The interplay of § 704(c)(1)(b) and § 737 ........................................... 6

#### 3. The like-kind exchange gambit ........................................... 6

### C. Section 731(c) .................................................. 7

## IV. THE EFFECTS OF A VALUATION DISCOUNT WITH A § 754 ELECTION ........................................... 7

### A. Overview .................................................. 7

### B. Mechanics .................................................. 7

#### 1. Calculating the total adjustment--§ 743 ........................................... 7

#### 2. Effect of a valuation discount ........................................... 9

### C. Allocating the adjustment--§ 755 ........................................... 10

#### 1. In general .................................................. 10

#### 2. Effect of a valuation discount ........................................... 11
POTENTIAL TAX TRAPS IN LIQUIDATING A FAMILY LIMITED PARTNERSHIP

I. OVERVIEW
In a typical family limited partnership, the older generation transfers assets to a limited partnership. The older generation makes lifetimes gifts of partial interests in the partnership, and the remaining interest passes to the younger generation at death. The interests conveyed during life and at death are discounted in value as minority interests and because of contractual restrictions on liquidity and the like. Taxpayers have claimed substantial valuation discounts sometimes in the order of 40 to 60 percent.

There has been much litigation and much written on the viability of a family limited partnership as an estate-planning device and the legal risks of steep valuation discounts. This outline does not traverse this familiar ground. It explores the possibility that §§ 704(c)(1)(B), 731(c), and 737 may require the estate or the successor in interest to recognize gain when the partnership is liquidated if the interest that passes at death is successfully discounted. It also discusses the effect of a valuation discount if there has been a § 754 election that requires § 743(b) adjustments in the basis of partnership assets.

When assets are distributed to the heirs non pro rata – i.e., the heirs take different assets – much and perhaps even all of any precontribution gain will be recognized on the distribution under §§ 704(c)(2), 731(c), and 737. Some argue a refuge may be found in a contributed property exception in §§ 731(c) and 737. In a non pro liquidation this exception is a partial refuge at best, for even if it applies to a transferee, much precontribution gain still will be recognized under § 704(c)(2). Moreover, there is good reason to think the distributed property exception in §§ 731(c) and 737 does not apply to a transferee, in which case all precontribution gain will be recognized. The trap in § 704(c) can be avoided by distributing assets pro rata. But the trap in section 737 still awaits in a pro rata liquidation if the contributed property exception does not apply to a transferee. The best advice is patience for the traps in §§ 704(c)(2) and 737 can be avoided by leaving assets in the partnership for seven years. But you must still beware the trap in § 731(c).

If a § 754 election is in effect, then a valuation discount will strip basis from intangible assets first (including intellectual property) until their basis is zeroed out, then from capital assets, and finally from ordinary assets.

The problems discussed in this outline largely disappear if a partnership interest is purchased for a price or is passed at death with an appraised value equal to the value of the transferee’s share of partnership assets. Gain is recognized under §§ 731(c) and 737 only if a partner receives cash and property in a distribution worth more than his basis in his interest. Thus, a step-up in a partner’s basis in his interest on purchase or inheritance eliminates gain under those provisions. Moreover, if the partnership makes a § 754 election, 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.

II. PRO RATA DISTRIBUTIONS
A. Section 737
1. In general
Section 737 was enacted in 1992 to limit tax-free transfers of appreciated assets through partnerships. It applies if a partner contributes an appreciated asset to a partnership and then within seven years receives a distribution of other property with a value in excess of his basis in his interest. Generally, the partner will recognize gain on the distribution equal to the lesser of his net precontribution gain on contributed assets or his excess gain on the distribution.

Example In 1996, A contributes Blackacre (worth $100, basis $40) to AB Partnership. B contributes $100 cash that is used to purchase Whiteacre. In 2002, Whiteacre is distributed to A in liquidation of his interest. If Whiteacre and Blackacre are worth more than $100 at the time of the distribution, then A will recognize his $60 precontribution gain on Blackacre in 2002.

Section 737 is a late addition to a quilt of rules changing what was once a general principle of nonrecognition on partnership distributions. It supplements § 704(c)(1)(B), which requires a partner who contributes property with precontribution gain or loss to recognize that gain or loss if the property is distributed to another partner within seven years of being contributed. Section 704(c)(1)(B) would apply

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1 Net precontribution gain is the gain that would be allocated to a partner under § 704(c)(1)(B) if a partnership sold all the property contributed by the distributee immediately prior to the distribution. Reg. §§ 1.737-1(c)(1), 1.704-4(a)(1). Rules defining precontribution gain and loss are found in Reg. § 1.704-3. A discussion of the possibility of purging an interest of precontribution gain under those rules is beyond the scope of this treatise. Generally, depreciation of an asset gradually reduces precontribution gain. The magnitude of the decrease depends upon the accounting method chosen under Reg. § 1.704-3. A decrease in asset value may also reduce or eliminate precontribution gain. The amount of precontribution gain realized on sale (or a deemed sale) of an asset equals the lesser of precontribution gain or actual (deemed) gain.

2 Excess gain is the value of property received in the distribution minus the transferee’s basis in his interest (after subtracting money received in the distribution).
in the example requiring A to recognize his precontribution gain if Blackacre was distributed to B. Section 704(c)(1)(B), in turn, supplements § 704(c)(1)(A), which requires that precontribution gain or loss be allocated to the contributing partner on the sale by the partnership of property bearing such gain or loss.

2. Transferees inherit precontribution gain

Under §§ 704(c) and 737 when a partner transfers an interest that bears precontribution gain the transferee steps into the transferor’s shoes as responsible for that gain. Thus, in the preceding example, if A gives his interest in AB partnership to C, C will step into A’s shoes, as responsible for the $60 precontribution gain on Blackacre. If a partner transfers a fractional partnership interest, the transferee takes a fractional share of the transferor’s responsibility for precontribution gain.

3. The contributed property exception

The contributed property exception in § 737 permits a partner to retrieve property he contributed to a partnership without recognizing gain. The exception achieves this result in two ways. The value of previously contributed property received in a distribution is not taken into account in determining the amount of the distribution and precontribution gain with respect to such property is disregarded in determining net precontribution gain. The following example from the regulations illustrates:

Example In 1995, A contributes property A1 (worth $20,000, basis $10,000) and property A2 (worth $10,000, basis $6,000) to ABC partnership. In 1998, property A2 (with the same value and basis) and other property worth $20,000 are distributed to A in complete liquidation of his interest. A’s basis in his interest at the time is $16,000. A recognizes $10,000 gain under § 737. This is both the amount of his net precontribution gain (the $10,000 on parcel A1 and disregarding the $6,000 on parcel A2) and the amount of the excess distribution ($20,000 other property minus $10,000 basis in his interest).

There is good reason to believe that the contributed property exception does not apply to a transferee. The regulations refer only to the original contributing partner. No mention is made of a transferee. This omission suggests that while a transferee succeeds to the transferor’s precontribution gain he does not come within the exception. This silence seems meaningful. Elsewhere the § 737 regulations and the § 704(c) regulations explicitly state when a transferee is within a rule. Moreover, the IRS has said informally that it will not rule that a transferee is within a similarly worded exception in the § 731(c) regulations.

Some commentators take the contrary position that the contributed property exception does apply to a transferee. They argue that § 737 is meant to address disguised sales of appreciated property through partnerships. A transfer of property through a partnership by gift or bequest is manifestly not a disguised sale. They also point to the § 704(c) regulations, which place a transferee in a contributing partner’s shoes for all purposes.

This position is fraught with difficulties, beginning with the text of the contributed property exception.

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3 Reg. § 1.737-1(c)(2)(iii)( stating the transferee “succeeds to the transferor’s net precontribution gain . . . .”)

4 The regulations state that when a transferee receives “a portion of a contributing partner’s partnership interest [he] succeeds to the transferor’s net pre-contribution gain, if any, in an amount proportionate to the interest transferred.” Reg. § 1.737-1(c)(2)(iii).

5 Reg. § 1.737-2(d)(1)( “Any portion of the distributed property that consists of property previously contributed by the distributee partner (previously contributed property) is not taken into account in determining the amount of the excess distribution or the partner’s net precontribution gain.”)

6 Reg. § 1.737-2(e), example 1.

7 Property A2 absorbs a $6,000 basis.


9 McKee, Nelson, & Whitmire, Federal Taxation of Partnerships and Partners, § 19.08[2][e], fn. 153 (“the step in the shoes rule should apply to all aspects of § 737 (e.g., the exception for distributions of previously contributed property provide by Reg. § 1.737-2(d), although the regulation by its terms is more limited.”); Ellen K. Harrison and Brian M. Blum, Another View: Responding to Richard Robinson’s “ ‘Don’t Nothing Last Forever”—Unwinding the FLP to the Haunting Melodies of Subchapter K,” 28 ACTEC J. 313, 315-317 (2003); Jerry M. Scroggins, Jr., Rewinding and Unwinding the Family Limited Partnership, 51st Annual Taxation Conference, University of Texas School of Law (Oct. 3, 2003). Only Harrison and Blum provide much in the way of argument. They ignore the significant differences in § 704(c)(1)(B) and § 737 and do not grapple with the implications of extending the exception to all transferees, in particular other non-recognition exchanges.

10 Reg. § 1.704-3(a)(7)(“If a contributing partner transfers a partnership interest, built in gain or loss must be allocated to a transferee as it would have been allocated to the transferor partner.”); Reg. § 1.704-4(d)(2)(“The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of § 704(c)(1)(B) and this § to the extent of built-in gain or loss allocated to the transferee partner.”)
exception in the § 737 regulations. While § 737 is adjunct to § 704(c) the two provisions address quite different situations. Section 704(c) generally identifies to whom will be allocated precontribution gain or loss realized by a partnership on disposition of an asset bearing such gain or loss. Section 737 speaks to whether a partner who receives property in a distribution with a value in excess of his basis in his partnership interest should recognize gain. Global application of the contributed property exception to transferees creates several problems. While these problems are fairly technical in nature they do suggest that had Treasury meant the exception to apply to transferees it would have said so and addressed the implications. Excluding transferees from the exception creates problems only when appreciated assets are passed in and out of a partnership within a seven year period and in addition a partnership interest is transferred in the interim at a discounted value in a taxable exchange or is transferred in a tax free exchange. Section 737 may not have been forged as a weapon to weld in the war against family limited partnerships, but it is nicely adaptable to that use. Rely on the exception at your peril.

4. Consequence if exception does not apply
The following example illustrates the application of § 737 in a simple scenario involving the transfer of wealth through a partnership with a valuation discount. It assumes the contributed property exception does not apply to a transferee. If the exception did apply no gain would be recognized on liquidation of the partnership.

Example In 1997, Father transfers undeveloped land worth $2,000,000 with a basis of $600,000 to a Limited Liability Company (“LLC”). He gives Daughter and Son each a 1% interest in the LLC valued at $10,000 representing a 50% discount. In 1998, 1999, 2000, and 2001 Father makes additional gifts of a 1% interest in the LLC each to Daughter and Son. Father dies in 2002. His remaining 90% interest in the LLC passes to Daughter and Son. The land has increased in value to $3,000,000. The 90% interest is appraised at $1,350,000 representing a 50% discount. Daughter and Son liquidate the LLC taking undivided interests in the land. Their aggregate basis in their interests is $1,410,000 and they receive property worth $3,000,000. They will recognize a gain of $1,400,000 which is the amount of Father’s precontribution gain in the land.

The younger generation could avoid gain recognition under § 737 if they delay liquidation until seven years pass from the contribution of the appreciated asset to the partnership. It is not clear what the precise effect of a § 754 election would be in the example. Generally, a discount in the value of the interest mutes the effect of a § 754 election.

B. Section 731(c)
Section 731(c) treats distributions of certain marketable securities as distributions of money equal to the securities’ fair market value at the time of the distribution. A partner recognizes gain on a distribution of money in excess of his basis in his interest. Section 731(c) applies regardless of how long the distributed securities were held by the partnership, whether the securities were contributed to or purchased by the partnership, whether the securities bore built-in gain when contributed, and whether the securities bear built-in gain when distributed. Section 731(c) does not apply to securities that were not marketable at the time they were contributed to the partnership subject to some other restrictions.

11 The most serious problems involve integrating the handling of the transferee in a carry-over basis transaction (e.g., a contribution of a partnership interest to a partnership or to a controlled corporation) with regulations §§ 1.737-2(b) and 2(c). If I were at Treasury, I would be reluctant to extend the contributed property exception to transferees globally until I had worked out the ramifications for tax-free transfers of partnership interests.
12 If a partnership interest is acquired in a taxable exchange for an undiscounted price, then the § 737 issue largely goes away. An elective basis adjustment eliminates precontribution gain. In the absence of an elective basis adjustment the buyer will recognize gain under § 737 only if the interest appreciates in value and he liquidates it within seven years of the contribution of the tainted property.
13 This is $1,350,000 basis of the 90% interest conveyed at death and $60,000 in the 10% interest conveyed during Father’s life.
14 The § 704 regulations merely state that “A partnership making adjustments under § 1.743-1(b) or 1.751-1(a)(2) must account for built-in gain or loss under § 704(c) in accordance with the principles of this §.” The § 755 regulations do not speak to the issue. Presumably if a purchaser paid fair market value for an interest he would be responsible for no precontribution gain. It unclear whether a purchaser who buys an interest at a discount also sheds responsibility for all precontribution gain. The issue is raised but is not addressed by Reg. § 1.755-1(b)(iii), example 2. The example in the text adds another wrinkle because some of the basis step-up is due to a post-contribution increase in the value of the land.
15 These generally are defined as financial instruments that are traded on an established financial market, § 731(c)(2)(A). Reg. § 1.1092(d)-1(a). § 731(c)(2)(B) expands the class to include certain surrogates and derivatives of marketable securities.
16 § 731(a)(1).
17 § 731(c)(3)(A)(ii). The security must have been held by the partnership at least six months before it became marketable and it must be distributed at least six months after it became marketable.
Section 731(c) does not apply to a distribution to an eligible partner by an investment partnership.  

Like § 737, § 731(c) provides an exception for securities the distributee contributed to the partnership. Like § 737, the § 731(c) regulations refer only to the contributing partner in defining who is within the scope of the exception. It is reported that the IRS has said informally that it will not issue a ruling that a donee is within this exception. 

Application of § 731(c) to a pro rata distribution from a family limited partnership often will not result in recognition of gain because of two rules. One is the general rule that a partner recognizes gain on a cash distribution only after his basis in the partnership is exhausted. The other is a rule that shields a distributee from recognizing gain on a distribution of marketable securities to the extent of his share of gain on like securities held by the partnership. Because of the latter rule it is better to distribute securities bearing built-in gain. The following example illustrates the impact of these two rules.

### Example

In 1994, Father transfers undeveloped land worth $1,000,000 with a basis of $300,000 and Dell stock worth $1,000,000 with a basis of $300,000 to a Limited Liability Company ("LLC"). He gives Daughter and Son each a 1% interest in the LLC valued at $10,000 representing a 50% discount. In 1998, 1999, 2000, and 2001 Father makes additional gifts of a 1% interest in the LLC each to Daughter and Son. Father dies in 2002. His remaining 90% interest in the LLC passes to Daughter and Son. The land has increased in value to $1,500,000 and the Dell stock has increased in $1,500,000. The 90% interest is appraised at $1,350,000 representing a 50% discount. Daughter and Son’s aggregate basis in their interests is $1,410,000. Their individual basis is $705,000. The Dell stock is distributed to Daughter and Son. Section 737 does not apply to the distribution though the Dell stock bears precontribution gain because the distribution is more than seven years after the contribution. While Dell stock worth $750,000 is distributed each to Daughter and Son they are deemed to have received a cash distribution of $150,000 because they subtract the $600,000 gain that would be allocated to them if the LLC sold the stock. The deemed cash distribution reduces their basis in their partnership interest to $555,000. They do not recognize gain. If the basis of the Dell stock had been $1,500,000 in the hands of LLC, then Daughter and Son would be deemed each to have received a cash distribution of $750,000 and each would recognize $45,000 gain.

These rules are less likely to cloak a distributee of publicly traded securities from recognizing gain on a non pro rata distribution. I turn to non pro rata distributions now.

### III. NON PRO RATA DISTRIBUTIONS

#### A. Section 704(c)(1)(b)

1. Introduction

Section 704(c)(1)(B) requires a contributing partner to recognize precontribution gain or loss on an asset if the asset is distributed to another partner within seven years of its being contributed.

**Example** A contributes Blackacre (worth $100, basis $40) to ABC Partnership. Six years later Blackacre is distributed to B. If Blackacre is worth $100 or more at the time of the distribution, then A will recognize his $60 precontribution gain on the distribution. If Blackacre is worth less than $100, then A will recognize that amount less his basis in his interest.

A distribution of property bearing precontribution gain or loss to the contributor does not trigger recognition of that gain or loss under § 704(c)(1)(B). If a contributor transfers his partnership interest to another person, the transferee steps into the contributor’s shoes for all purposes under § 704(c). Thus, in the example, if A transferred his entire partnership interest to D, who later received Blackacre in a distribution, no gain would be recognized by D on the distribution. If a contributor transfers part of his partnership interest to another person, the transferee steps into the contributor’s shoes for that part of the contributor’s precontribution gain or loss. This rule should shield everyone from recognizing gain if a contributor divides his interest in a partnership among multiple transferees so long as the asset bearing precontribution gain is distributed pro rata among the class of transferees.

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18 § 731(c)(3)(C). Generally, an investment partnership is a partnership that has never engaged in a trade or business and has always held financial assets as substantially all of its assets. An eligible partner is a partner who contributed only financial assets.

19 § 731(c)(3)(A)(i).

20 Reg. § 1.731-2(d)(1)("§ 731(c) and this § do not apply to the distribution of a marketable security if-(i) the security was contributed to the partnership by the distributee partner").


22 § 731(a)(1).

23 § 731(c)(3)(B).

24 This is $1,350,000 basis of the 90% interest conveyed at death and $60,000 in the 10% interest conveyed during Father’s life.

25 Reg. §§ 1.704-3(a)(7) and § 1.704-4(d)(2).

26 This comes within Reg. § 1.704-4(d)(6), which states: "§ 704(c)(1)(B) and this § do not apply to a distribution of an undivided interest n property to the extent that the undivided interest does not exceed the undivided interest, if any,


Example  In 1997, Father transfers land worth $2,000,000 with a basis of $600,000 to LLC. Through a series of inter vivos gifts and a bequest Father transfers to Daughter and Son each half interests in LLC. After Father dies Daughter and Son liquidate LLC taking undivided half interests in the land. Because Daughter and Son are each considered to be the contributor of a half interest in the land no gain is recognized under § 704(c)(1)(B).

2. The sting in a non pro rata distribution

Section 704(c)(1)(b) has a sting if property bearing precontribution gain or loss is distributed non pro rata among the class of transferees. A transferee who relinquishes his interest in distributed property bearing precontribution gain or loss will recognize such gain or loss on the distribution. The following example illustrates. I defer discussion of the effects of § 737.

Example In 1997, Father transfers three properties to LLC. The properties are not like-kind within the meaning of § 1031. Property 1 is worth $900,000 and has a basis of $600,000. Property 2 is worth $1,200,000 and has a basis of $600,000. Property 3 is worth $800,000 and has a basis of $650,000. Through a series of inter vivos gifts and a bequest Father transfers to Older Daughter, Son, and Younger Daughter each one third interests in LLC. After Father dies Older Daughter receives Property 1, then worth $900,000, plus $100,000 cash, in liquidation of her interest in LLC. Son and Younger Daughter each recognize $100,000 gain on the distribution of Property 1. This is their one-third share of the precontribution gain.

Gain under § 704(c)(1)(B) can be avoided by making distributions pro rata among the class of transferees or by delaying the distribution of property bearing precontribution gain until seven years after the contribution of the property. An exception eliminates gain under § 704(c)(1)(B) if a non pro rata distribution could be reconfigured as a pro rata distribution followed by a like-kind exchange.27 I defer discussion of the exception because gain will still be recognized under § 737, which has no such exception.

B. Section 737

1. In general

A non pro rata distribution may result in recognition of gain even if the contributed property exception applies to a transferee. Generally, assuming the exception does apply, under § 737 a distributee will recognize gain equal to the lesser of (a) the value of the property and cash he receives in the distribution minus his basis in his interest; or (b) his net precontribution gain on partnership property, in both instances disregarding the value of previously contributed property received in the distribution and precontribution gain attributable to such property.

The next example shows the effect of a non pro distribution assuming the contributed property exception applies to a transferee.

Example In 1997 Father transfers three properties28 to LLC. At all relevant times, Property 1 is worth $900,000 and has a basis of $600,000. Property 2 is worth $1,200,000 and has a basis of $600,000, and Property 3 is worth $900,000 and has a basis of $750,000. Through a series of inter vivos gifts and a bequest Father transfers to Older Daughter, Son, and Younger Daughter one third interests in LLC. In 2003 Older Daughter receives Property 1, worth $900,000, plus $100,000 cash in liquidation of her interest in LLC. The tax consequences of this distribution to Son and Younger Daughter under § 704(c)(1)(B) are explained in the preceding example. Assume Older Daughter has a $500,000 basis in her interest. Older Daughter is treated as having received a distribution of $100,000 cash and property worth $600,000 ($900,000 minus the value of her one-third interest in Property 1) against a basis of $500,000. Her net precontribution gain on relinquished property is $250,000 ($200,000 on Property 2 and $50,000 on Property 3). Because the first number is less Older Daughter recognizes $100,000 gain.

If the contributed property exception does not apply to a transferee, then Older Daughter is treated as having received a distribution of $900,000 – she does not back out her fractional interest in Property 1 because it is not considered property contributed by her. Thus, she would recognize her entire net precontribution on Property 2 and Property 3 ($250,000).
2. The interplay of § 704(c)(1)(b) and § 737

The next example illustrates the interplay of § 704(c)(1)(B) and § 737 in a complete liquidation. Section 704(c)(1)(B) is applied first, § 731(c) second, and § 737 last. Generally, if the contributed property exception applies to a transferee, a partner will recognize his share of precontribution gain on assets distributed to other partners under § 704(c)(1)(B) unless the assets are like-kind. He will defer tax on his share of precontribution gain on the asset he receives in the distribution. If the exception does not apply to a transferee, then everyone will recognize all of their precontribution gain on a liquidation and non pro rata distribution.

Example The same facts as the preceding example. The properties are not like kind within the meaning of § 1031. In 2003 when LLC liquidates Property 1 is worth $900,000, Property 2 is worth $1,200,000, and Property 3 is worth $900,000. Older Daughter receives Property 1. Son receives Property 2. Younger Daughter receives Property 3. Son contributes $200,000, which is split between Older Daughter and Younger Daughter to equalize distributions. Each child has a basis of $500,000 in their interest prior to the liquidation.

Older Daughter recognizes $250,000 gain under § 704(c)(1)(B) (her $200,000 precontribution gain on Property 2 and $50,000 precontribution gain on Property 3). If the contributed property exception applies to a transferee, she recognizes no additional gain under § 737.29 If it does not apply, she recognizes her remaining precontribution gain of $100,000.

Son recognizes $150,000 gain under § 704(c)(1)(B) (his $100,000 precontribution gain on Property 1 and $50,000 precontribution gain on Property 3). If the contributed property exception applies to a transferee, Son recognizes no additional gain under § 737.30 If it does not apply, he recognizes his remaining precontribution gain of $200,000.

Younger Daughter recognizes $300,000 gain under § 704(c)(1)(B) (her $100,000 precontribution gain on Property 1 and $200,000 precontribution gain on Property 2). If the contributed property exception applies, Younger Daughter recognizes no additional gain under § 737.31 If it does not apply, she recognizes her remaining precontribution gain of $50,000.

3. The like-kind exchange gambit

If distributed properties are like-kind within the meaning of § 1031, an exception under § 704(c) for distributions of like-kind property will eliminate or reduce the § 704(c) gain. The exception applies if § 704(c) property is distributed and then generally32 within 180 days like-kind property is distributed to the contributing partner (or his transferee).33 The amount of § 704(c) gain the contributing partner would otherwise recognize is reduced by the amount of built-in gain on the like-kind property he receives in the distribution. There is no exception in § 737 to cover the situation where non pro rata distributions could be restructured as pro rata distributions followed by a tax-free like-kind exchanges of partial interests in the distributed property. The application of § 737 produces the same result as in the example by a different path.

Example The same facts as in the preceding example except the three properties are like kind within the meaning of § 1031. Older Daughter would recognize $250,000 gain under § 704(c)(1)(B). This is wiped out because she has $500,000 built-in gain on Property 1.34 If the contributed property exception applies to a transferee, she has $250,000 net precontribution gain35 and an excess distribution of $600,000.36 Thus, Older Daughter recognizes $250,000 gain under § 737. She increases her basis in Property 1 to $650,000. If the contributed property exception does not apply to a transferee, then Older Daughter would recognize $350,000 gain under § 737 and she would take a $750,000 basis in Property 1.

is no excess distribution because only $600,000 of the value of Property 3 is taken into account.

32 The regulations provide that like-kind property must be distributed the earlier of 180 days following the distribution of § 704(c) property or due date of the contributing partner’s tax return for the year the § 704(c) property was distributed.

33 Reg. § 1.704-4(d)(3). While the text of the regulation says that the distribution of like-kind property must follow the distribution of § 704(c) the example applies the exception to a simultaneous distribution. Reg. § 1.704-4(d)(4).

34 While the inside basis of Property 1 is $600,000 Older Daughter takes a $400,000 basis in it because that is her basis in her partnership interest. This assumes that her basis is first reduced by the $100,000 cash distribution. The regulation on like-kind distribution states: “The contributing partner’s basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same distribution. . . .” Reg. § 1.704-4(d)(3)(emphasis added).

35 $350,000 net precontribution gain minus the $100,000 precontribution gain on Property 1.

36 Property 1 is valued at $600,000 for purposes of calculating the excess distribution. Older Daughter has a zero basis in her partnership interest because Property 1 absorbed her entire basis.

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29 She has no further precontribution gain because the $100,000 attributable to Property 1 is disregarded. Also there is no excess distribution because only $600,000 of the value of Property 1 is taken into account.

30 He has no further precontribution gain because the $200,000 attributable to Property 2 is disregarded. Also there is no excess distribution because only $800,000 of the value of Property 2 is taken into account.

31 She has no further precontribution gain because the $50,000 attributable to Property 3 is disregarded. Also there
C. Section 731(c)

Non pro rata distributions of marketable securities are more likely to result in recognition of gain under § 731(c). Recall that, subject to certain exceptions, marketable securities are treated as money on a distribution, meaning the distributee will recognize gain if the value of the securities exceeds his basis in his partnership interest. The amount of the deemed distribution is reduced by the distributee’s share of gain with respect to the distributed securities.  

Example In 1994, Father transfers undeveloped land worth $1,000,000 with a basis of $300,000 and Dell stock worth $1,000,000 with a basis of $300,000 to a Limited Liability Company (“LLC”). He gives Daughter and Son each a 1% interest in the LLC valued at $10,000 representing a 50% discount. In 1998, 1999, 2000, and 2001 Father makes additional gifts of a 1% interest in the LLC each to Daughter and Son. Father dies in 2002. His remaining 90% interest in the LLC passes to Daughter and Son. The land has increased in value to $1,500,000 and the Dell stock has increased in value to $1,500,000. The 90% interest is appraised at $1,350,000 representing a 50% discount. Daughter and Son’s aggregate basis in their interests is $1,410,000. Their individual basis is $705,000. The Dell stock is distributed to Daughter and the land is distributed to Son.. Section 704(c)(1)(B) and § 737 do not apply because the distributions are outside the seven year window. If the contributed property exception in § 731(c) does not apply to a transferee, Daughter is treated as if she received a distribution of $1,500,000 reduced by $600,000 for her share of the gain on the Dell stock. Thus, there is a deemed cash distribution of $900,000 to Daughter and she recognizes $195,000 gain. If the contributed property exception applies to a transferee, then the deemed distribution would be $150,000 ($750,000 for the half of the securities attributable to Son minus Daughter’s $600,000 gain with respect to the securities), and Daughter would not recognize gain on the distribution.  

As explained earlier, there is good reason to believe that the contributed property exception in § 731(c) does not apply to a transferee.

IV. THE EFFECTS OF A VALUATION DISCOUNT WITH A § 754 ELECTION

A. Overview

A valuation discount decreases the basis of the decedent’s partnership interest at death. This will not alter the basis of the assets in the partnership’s hands unless the partnership has elected to make basis adjustments under § 743(b) or unless basis adjustments are required because there is a substantial built-in loss on partnership assets. If the § 754 election has been made it cannot be revoked without the consent of the IRS.  

Basis adjustments are required if the basis of partnership assets exceeds their fair market value by more than $250,000. There is an exception for electing investment partnerships.

The principle behind the basis adjustments is straightforward. It is to preserve equality between “outside” and “inside” basis (meaning the basis of the partner in his interest and the basis of the partnership in its assets) in order to prevent the artificial and transitory gains and losses that arise when outside and inside basis diverge. The adjustments generally are made elective, though they are correct in principle, because their mechanics can be quite complex.

Adjustments were made mandatory in 2004 for partnerships with a substantial built-in loss in response to a spate of loss-duplicating tax transactions around the turn of the millennium.

B. Mechanics

1. Calculating the total adjustment--§ 743

The total adjustment of inside basis equals the transferee’s basis in the partnership interest (the fair market value of the interest plus the transferee’s share of partnership liabilities minus IRD items) minus the

37 § 731(c)(3)(B).
38 This is $1,350,000 basis of the 90% interest conveyed at death and $60,000 in the 10% interest conveyed during Father’s life.
39 2004 legislation aimed at transactions designed to duplicate tax losses make the § 743(b) adjustments mandatory when there is a substantial built-in loss in partnership assets. American Jobs Creation Act of 2004 § 833. A substantial build in loss exists when “the partnership’s adjusted basis in partnership property exceeds by more than $250,000 the fair market value of such property.” I.R.C. § 743(d)(1). The rule is effective for transfers after the date of enactment.
40 I.R.C. § 743(d)(1).
41 Electing investment partnerships are subject to an alternative partner-level loss limitation that allows a transferee to recognize a built-in loss if that same loss was not recognized by the transferor on the transfer of the interest. I.R.C. § 743(e)(2). This requirement is satisfied if an interest is transferred at death or by gift. To be an electing investment partnership the partnership must so elect; the partnership would be an investment company under § 3(a)(1)(A) of the Investment Company Act but for an exemption under 3(c)(1) or 3(c)(7); it must never have been engaged in a trade or business; substantially all of its assets must be held for investment; at least 95 percent of the assets contributed must be cash; no asset can be contributed bearing built-in loss; all interests must be issued within 24 months of the first capital contribution; there must be substantive restrictions on a partner’s right to redeem their interest; and the partnership agreement cannot be for a term of more than 15 years. I.R.C. § 743(e)(6). A venture capital fund organized as a partnership is an example of a partnership likely to be within the definition.
transferee’s share of the adjusted basis of all partnership property (or his share of inside basis). In the simple case where partners share equally in capital and profits and where there are no special adjustments in effect to account for built-in gain or loss on contributed property, the transferee’s share of inside basis will be a pro rata share of the adjusted basis of partnership property. Thus, a one-third partner will take one-third of the adjusted basis of partnership property.

Example A is a one-third partner in ABC partnership, which holds Blackacre (worth $30, basis $15), Whiteacre (worth $10, basis $10), and $20 cash at the time of A’s death. The estate’s interest is valued at $20. The estate’s share of the adjusted basis of partnership property is $15 (one-third of $45). The amount of the adjustment is $5.

Regulations issued and effective in 1999 integrate the rules on allocation of built-in gain or loss under section 704(c) with the calculation of the transferee’s share of inside basis. This is done by the concept of a transferee’s share of “previously taxed capital.” This is added to a transferee’s share of partnership liability to determine the transferee’s share of the adjusted basis of partnership property. Previously taxed capital equals: the amount of cash the transferee would receive if the partnership sold all of its assets for cash at fair market value and distributed cash immediately after the transfer; plus any tax losses that would be allocated to the transferee on the sale; and minus any tax gains that would be allocated to the transferee on the sale.

Example A contributes Blackacre for a one-third interest in ABC partnership. At the time Blackacre is worth $1,000 and has a basis of $400. Rules in section 704(c) require that this $600 built-in gain be allocated to A should Blackacre be sold. B and C each contribute $1,000, and Blackacre appreciates in value to $1,300. A dies leaving his interest to W. At the time of A’s death the partnership holds Blackacre and $2,000 cash. The interest is valued at $1,100. W’s share of previously taxed capital or inside basis equals $400. This is determined by taking the amount of cash that would be distributed to W if the partnership sold Blackacre for $1,300 and liquidated – $1,100 – and subtracting the gain that would be allocated to W on the sale of Blackacre – $700. The basis adjustment attributable to W is $700.

In this example an inside basis adjustment simply eliminates gain attributable to A’s interest at death. Shortly you will see that the rules on allocating basis adjustments in Section 755 eliminate both tax gain and tax loss when they offset. Thus it might seem possible to reduce Sections 743(b) and 755 to the simple rule that all inside tax gain not attributable to an IRD item or inside tax loss attributable to the interest of a dead partner is eliminated if a Section 754 election is made or basis adjustments are required because of loss assets. The more complex mechanics of Section 743(b) produce results that diverge from this simple rule when the ceiling rule in Section 704(c) prevents full allocations of built-in gain or loss. Those seeking an explanation of this recondite point may consult the footnote.

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42 Reg. § 1.743-1(b)(1).
43 The regulations apply to transfers of partnership interests that occur after December 15, 1999. Reg. § 1.743-1(i). Under the old regulations the method for calculating the transferee’s share of the adjusted basis of partnership property is to take the amount stated in the transferee’s partnership capital account, add the transferee’s share of partnership liabilities, and finally make whatever adjustments are necessary to account for the transferee’s share of built-in gain or loss (subtracting the former and adding the latter). Old Reg. §§ 1.743-1(b)(1), & Ex. (2), 1.743-1(b)(2)(i), Ex. (2).
44 Reg. § 1.743-1(d)(1).
45 Reg. § 1.743-1(d)(2). The regulations do not speak to whether in the case of § 197 intangibles this is their actual fair market value or their assigned value as determined under the § 755 regulations that implement the residual value method of § 1060. § 1060(d) states its rules “shall apply but only for purposes of determining the value of § 197 intangibles for purposes of applying § 755.” This could be read to mean that residual value method is not used under § 743(b). On the other hand, § 743(b) always works in conjunction with § 755. Happily the choice between actual and assigned value generally should not affect the calculation of previously tax capital for the purpose of the exercise is to determine the transferee’s share of inside basis, which generally is not a function of asset value. A possible exception is when there is an asset bearing built-in gain or loss attributable to the transferee and the ceiling rule is in effect under § 704(c).
46 This example is based upon Reg. § 1.743-1(d)(3), Ex. (2).
47 To illustrate, take the same facts as the preceding example in text but assume Blackacre goes down in value to $700. The partnership would have a $300 book loss on the sale of Blackacre but a $300 tax gain. In principle, the correct result is that A should have a $500 net tax gain (the original $600 gain minus the $100 loss) and B and C each should have a $100 loss. The ceiling rule prevents this: total items allocated to partners with respect to a property in a year cannot exceed total partnership items with respect to that property in that year. Reg. § 1.704-3(b)(1). The § 704(c) regulations enable partners to avoid the ceiling rule by electing to make curative allocations or remedial allocations rather than using the traditional method. In the example using curative allocations, the partnership would look for a $200 tax loss item to allocate to A and a $200 tax gain item to split between B and C. Using remedial allocations, A would be allocated a $500 tax gain and B and C each would be allocated a $100 tax loss.

The mechanism of the hypothetical sale carries through the effects of whatever method the partners chose under the § 704(c) regulations to determine a transferee’s share of the adjusted basis of partnership property under § 743(b). In the
2. **Effect of a valuation discount**

A discount in the value of an interest passed at death also complicates matters. The transferee’s basis in his partnership interest determines the amount of the overall inside basis adjustment. Recall the basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of death or the alternative valuation date, increased by the estate or successor’s share of partnership liabilities, and reduced by value attributable to IRD items.\(^48\) Thus the effect of a discount in the value of an interest is to reduce the amount of the overall inside basis adjustment leaving tax gain inside the partnership and perhaps even reducing inside basis to increase tax gain inside the partnership.

**Example** The same facts as above except the interest received by W is valued at $900 as an illiquid minority interest in a partnership that holds substantial real estate. As above W’s share of previously taxed capital or inside basis equals $400. W will get a $500 inside basis adjustment (W’s outside basis minus W’s share of inside basis) and recognize $200 gain if Blackacre is sold for $1,300.

Depending on the types of assets held by a partnership the rules in § 755 on allocating basis adjustments among assets can either ameliorate or harshen the negative effect of a discount in the valuation of an interest. These rules are discussed below.

The presence of IRD items creates no special problems when a partnership interest is not discounted. Reducing outside basis by the value of the IRD items preserves the tax on the IRD items, which by nature tend to have a zero basis. The presence of significant IRD items may present a problem if an interest is discounted in value. The problem arises if the successor’s basis in the interest is reduced by the

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\(^48\) Reg. § 1.742-1.

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This is the appraised value of a 90% interest, $1,980,000, minus the fair market value of a 90% interest in the options, $1,350,000.

\(^49\) Reg. § 1.742-1. The relevant text with emphasis supplied is: “The basis of a partnership interest acquired from a decedent is the fair market value of the interest . . . reduced to the extent that such value is attributable to items constituting income in respect of a decedent . . . .” Reg. § 1.1367-1(j), which provides for similar adjustment in the basis of S Corporation stock, also supports this reading. It states “The basis determined under § 1014 of any stock in an S corporation is reduced by the portion of the value of the stock that is attributable to items constituting income in respect of a decedent.”
discounts deemed appropriate to each type of asset. However, these cases may give cold comfort for those seeking significant valuation discounts on unrealized rights to cash, near cash equivalents, and securities because the Tax Court adopted fairly low discount rates on such assets. Most IRD items are of this nature. To the extent the value of IRD items cannot be discounted, the presence of significant IRD items in partnership with an interest bearing a significant discount in value will be as in the preceding example.

C. Allocating the adjustment—§ 755

1. In general

The rules for allocating basis adjustments among partnership assets have changed significantly in recent years. Under final regulations issued in 2003 the effect of a basis adjustment is straightforward when the fair market value of an asset that passes at death equals the fair market value of the decedent’s interest in partnership assets in the hands of the partnership.

The amount of the adjustment for each non-IRD asset will equal the amount of tax gain or loss that would be allocated to the decedent’s successor upon a hypothetical sale of that asset at the time of death or the alternative valuation date. No adjustment is made in IRD items. As a consequence all inside tax gain or loss attributable to the decedent’s interest will be wiped out except gain attributable to IRD items.

Example At the time of A’s death ABC partnership owns building x (value $60, basis $40), building y (value $40, basis $50), inventory (value $50, basis $30), and a zero basis $9 receivable. A’s one-third interest is valued at $53. The estate takes a $50 basis in the partnership interest ($53 fair market value minus the $3 receivable, which is an IRD item). The estate’s share of the adjusted basis of partnership property is $40. The total adjustment equals $10. On the hypothetical sale, A’s estate would be allocated $6.66 ordinary income on inventory, $6.66 capital gain on building x, and $3.33 capital loss on building y. Each asset receives a basis adjustment of this amount wiping out inside gain and loss on all but the receivable. The Section 755 regulations are considerably more complex because of the need to address situations where the value or purchase price of a partnership interest differs from the value of the partner’s interest in underlying partnership assets. Generally, and with some over-simplification, when the assets of a partnership constitute a trade or business, a discount in value will be absorbed first by section 197 intangibles in ascertaining their value, then by capital assets as a class, and finally by ordinary income assets as a class. If a class does not absorb a discount, then all tax gain or loss attributable to the transferred interest on assets within the class is wiped out. If a class does absorb a discount, then tax gain


52 Under old Reg. § 1.755-1(a)(1) class and individual asset basis adjustments had to be in the same direction as the total adjustment. Thus, if the total adjustment was positive asset basis could only go up. This rule prevented adjustments to fair market value when a partnership had both gain and loss assets. Adjustments were done first by class — capital assets (including § 1231(b) property) and ordinary assets — and then by assets within a class. The adjustment was allocated between the classes in proportion to the difference between value and basis for each class and then it was allocated among assets within a class in proportion to the difference between value and basis for each asset. The following example shows how the old regulations produced discrepancies between basis and value when a partnership held gain and loss assets.

Example At the time of A’s death ABC partnership owns building x (value $60, basis $40), building y (value $40, basis $50), and inventory (value $50, basis $30). A’s interest is valued at $50. The estate’s share of the adjusted basis of partnership property is $40. The total adjustment is $10. Together the buildings have $10 gain and the inventory has $20 gain. The $10 adjustment is allocated one-third to building A and two-thirds to the inventory.

53 Reg. § 1.755-1.

54 Reg. § 1.755-1(b)(4).

55 Reg. § 1.755-1(b)(2). A trade or business is described in § 1.1060-1(b)(2), which first directs one to the definition of an active trade or business under § 355 meaning § 1.355-3(b)(2). An active trade or business involves “substantial management and operational functions” and excludes holding of property for investment and passive leasing. The § 1060 regulations also include within the definition of a trade or business a group of assets of such character “that goodwill or going concern value could under any circumstances attach to such group.” Reg. § 1.1060-1(b)(2)(B).

56 § 197 intangibles include intellectual property such as patents, copyrights and trademarks; licenses or permits; information bases such as customer lists; covenants not to compete; and goodwill and going concern value. I.R.C. § 197(d). The definition excludes financial interests, interests in land, computer software not acquired in the acquisition of assets constituting a trade or business, patents and copyrights not acquired in the acquisition of assets constituting a trade or business, and sports franchises. I.R.C. § 197(e).

57 This includes § 1231(b) property but not gain that would be ordinary income under § 1245 as depreciation recapture, which is treated as a separate § 751(c) receivable.

58 The regulations state that “properties and potential gain treated as unrealized receivables under § 751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property.” Reg. § 1.755-1(a)(1). 751(c) receivables that are IRD items will not benefit from the adjustment.
attributable to the transferred interest is spread across all assets in the class in proportion to their value. Thus, a significant discount may wipe out any basis attributable to the transferred interest in section 197 intangibles by assigning no value to section 197 intangibles and leave a tax gain spread across capital assets while wiping out tax gain and loss on ordinary income assets.

2. Effect of a valuation discount

The designers of these rules had in mind the purchase of a partnership interest at a dickered price in a situation where we are skeptical about the values the parties privately assign to section 197 intangibles. A value is assigned to section 197 intangibles only if the purchase price of the interest exceeds the value of other assets. A consequence is to strip value (and ultimately basis) from section 197 intangibles if a low value is assigned to a partnership interest that passes at death when the assets of a partnership constitute a trade or business. A discount in the valuation of an interest can have a dramatic adverse effect if a partnership holds significant intellectual property or other assets that are considered section 197 intangibles.

**Example**

At the time of A’s death ABC partnership owns intellectual property worth $80, tangible property worth $150, and receivables worth $10. The assets of the partnership are considered a trade or business. The intellectual property is a section 197 intangible. A’s one-third interest passes to D and is valued at $60 as an illiquid minority interest. The value assigned to the intellectual property is $15. Partnership gross value is $180, which is what the total value of partnership assets would be to make a liquidating distribution to D of $60. From this $180 is subtracted the actual value of the tangible property ($150) and the receivables ($15) to determine the residual value assigned to the intellectual property.

The assigned values of section 197 intangibles and the actual values of other assets are used to determine the tax gain or loss that would be allocated to the transferee partner upon a hypothetical sale of the assets for cash immediately after the transfer. The total basis adjustment determined under Section 743(b) comes into play at this stage. First take the class of ordinary income assets. Adjustments equal to the tax gain or loss that would be allocated to the transferee upon the hypothetical sale are made for all assets in the class in proportion to their value. The upshot of this is that a discount in value will be borne by capital assets in proportion to their fair market value. The built-in gain is spread across assets to limit the potential for cherry-picking.

The example, which is based upon an example in the regulations, illustrates without Section 197 intangibles and IRD items.

**Example** A contributes $50,000 cash and asset 1, which has a fair market value of $50,000 and a basis of $25,000, to AB Partnership. B contributes $100,000 cash. Later A dies and leaves his interest to T. At the time AB partnership holds two capital assets – Asset 1 (value $75,000, basis $25,000) and Asset 2 (value $117,500, basis $100,000) – and two ordinary income assets – Asset 3 (value $45,000, basis $40,000) and Asset 4 (value $2,500, basis $10,000). Assume the gain on Asset 3 is not an IRD item. The interest is valued at $110,000 though a half interest in partnership assets is worth $120,000. T’s total adjustment equals $35,000. The gain attributable to T on Asset 3 is $2,500 and the gain attributable to T on Asset 4 is $3,750. The total net adjustment in ordinary income property is $1,250. The residual basis adjustment allocated to capital gain property is $36,250. The gain attributable to T on Asset 1 is $37,500 and the gain attributable to T on Asset 2 is $8,750. This sums to $46,250, which exceeds the basis adjustment allocated to capital gain property by $10,000. There is a $10,000

outside basis is not sufficient to support a fair market value basis in capital assets. In this situation, the inside tax gain is spread across all ordinary income assets in proportion to their actual or assigned values. Reg. § 1.755-1(b)(3)(i).

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59 See note 56 for a definition of § 197 intangibles.
60 Reg. § 1.755-1(b)(1)(ii).
61 It is possible that the aggregate net adjustment in ordinary income assets will exceed the total basis adjustment determined under § 743(b). This means that the transferee’s aggregate net adjustment in ordinary income assets from the total basis adjustment determined under Section 743(b). Then turn to the capital asset class. Total up the tax gain or loss that would be allocated to the transferee upon the hypothetical sale of capital assets. If this amount equals the residual total basis adjustment, then each asset in the capital asset class will take an adjustment equal to the tax gain or loss that would be allocated to the transferee upon a hypothetical sale. If this amount exceeds the residual total basis adjustment – i.e., the transferee’s outside basis is not sufficient to support a fair market value inside basis in capital assets – then the tax gain is spread across all capital assets in proportion to their actual or assigned values. The upshot of this is that a discount in value will be borne by capital assets in proportion to their fair market value. The built-in gain is spread across assets to limit the potential for cherry-picking.

The example, which is based upon an example in the regulations, illustrates without Section 197 intangibles and IRD items.

**Example** A contributes $50,000 cash and asset 1, which has a fair market value of $50,000 and a basis of $25,000, to AB Partnership. B contributes $100,000 cash. Later A dies and leaves his interest to T. At the time AB partnership holds two capital assets – Asset 1 (value $75,000, basis $25,000) and Asset 2 (value $117,500, basis $100,000) – and two ordinary income assets – Asset 3 (value $45,000, basis $40,000) and Asset 4 (value $2,500, basis $10,000). Assume the gain on Asset 3 is not an IRD item. The interest is valued at $110,000 though a half interest in partnership assets is worth $120,000. T’s total adjustment equals $35,000. The gain attributable to T on Asset 3 is $2,500 and the gain attributable to T on Asset 4 is $3,750. The total net adjustment in ordinary income property is $1,250. The residual basis adjustment allocated to capital gain property is $36,250. The gain attributable to T on Asset 1 is $37,500 and the gain attributable to T on Asset 2 is $8,750. This sums to $46,250, which exceeds the basis adjustment allocated to capital gain property by $10,000. There is a $10,000
downward basis adjustment allocated to the capital assets in proportion to their relative fair market value. Asset 1 absorbs $3,896 of the $10,000 decrease ($10,000 X $75,000/192,500) and Asset 2 absorbs $6,104 ($10,000 X $117,500/192,500). At the end of the analysis Asset 1 has a net positive adjustment of $33,604 and Asset 2 has a net positive adjustment of $2,646. T has no further built-in gain or loss on the ordinary income assets. He has $10,000 built-in gain attributable to the capital assets spread across the assets in proportion to their fair market value.

The next example introduces Section 197 intangibles, an IRD item, and a substantial discount in the valuation of the interest. It illustrates how valuing Section 197 intangibles with the residual method creates built-in gain in such assets when there is a discount in the value of the interest.

Example A contributes a patent worth $20 with a basis of zero to ABC partnership. B and C each contribute $20 cash. At time of A’s death ABC partnership has the following assets:

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intellectual property</td>
<td>$0</td>
<td>$80</td>
</tr>
<tr>
<td>Tangible capital asset</td>
<td>$60</td>
<td>$90</td>
</tr>
<tr>
<td>Inventory</td>
<td>$45</td>
<td>$60</td>
</tr>
<tr>
<td>Receivable</td>
<td>$0</td>
<td>$15</td>
</tr>
</tbody>
</table>

The assets of the partnership are considered a trade or business. The intellectual property is a section 197 intangible. I assume it is treated as a capital asset in the hands of the partnership. A’s one-third interest passes to D and is valued at $60 as an illiquid minority interest. The value assigned to the intellectual property is $15. D’s total adjustment equals $30. Of this $5 is absorbed by the inventory eliminating the gain attributable to D. The residual adjustment is $25. Of this $10 goes to the tangible capital asset and $15 goes to the intellectual property, which is the gain attributable to A on both assets valuing the intellectual property by the residual value method.

If the assets of the partnership were not considered a trade or business, then the gain would have been spread across the intellectual property and the tangible capital asset.

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66 D’s basis in the interest (value minus IRD items) equals $55. D’s share of previously taxed capital or inside basis equals $25, which is the cash that would be distributed to D upon a hypothetical sale and liquidation ($60) minus the gain that would be allocated to D upon the hypothetical sale ($35 summing $15 on the intellectual property, $10 on the capital asset, $5 on the inventory, and $5 on the receivable). These calculations value the intellectual property using the residual method and assume the ceiling rule is in effect.