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MARY E. VANDENACK, JOY MATAK & MARTIN M. SHENKMAN: NOTES FROM THE 58TH HECKERLING INSTITUTE ON ESTATE PLANNING, PART 2

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #3094

Date:	24-Jan-24
From:	Steve Leimberg's Estate Planning Newsletter
Subject:	Mary E. Vandenack, Joy Matak & Martin M. Shenkman: Notes from the 58th Heckerling Institute on Estate Planning, Part 2

The 58th Heckerling Institute on Estate Planning was held January 8 through January 12, at Marriott World Center in Orlando, Florida. Members should click this link to review the meeting agenda: Heckerling

The Heckerling Institute on Estate Planning covers a range of topics for estate planning professionals, including practical pointers that will assist practitioners whether their clients are high net worth individuals or more moderate net worth clients.

Mary E. Vandenack, Joy Matak and Martin M. Shenkman attended the Heckerling Institute on Estate Planning and agreed to share their notes. Because of the length of the proceedings and the detailed notes, the notes are being separated into five parts and will be published as a series.

Mary E. Vandenack, J.D., ACTEC, CAP®, COLPM®, Accredited Estate Planner (Distinguished) is a partner in the Omaha office of DUGGAN BERTSCH, LLC. Mary is a highly regarded practitioner in the areas of tax, trusts and estates, private wealth planning, asset protection planning, business exit and succession planning, and philanthropic strategies. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers, companies in the financial industry, and tax-exempt organizations. Mary is a member of the Entrepreneurs Organization. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves on Council. Mary is a member of the American Bar Association Law Practice Division where she currently serves as Chair. Mary has been named to ABA LTRC Distinguished Women of Legal Tech, received the James Keane Award for e-lawyering, and serves on ABA Standing Committee on Information and Technology Systems. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning

topics as well as on practice management topics including improving the delivery of legal services, technology in the practice of law and process automation. Mary hosts a podcast called Legal Visionaries. https://maryvandenack.com/podcast/

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Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in New York who concentrates on estate planning. He is the author of 42 books and more than 1,400 articles. He is a member of the NAEPC Board of Directors (Emeritus), served on the Board of the American Brain Foundation, the American Cancer Society's National Professional Advisor Network, Weill Cornell Medicine Professional Advisory Council, and is active in other charitable organizations.

Joy Matak, JD, LLM is a Partner at Avelino Law. She has more than 20 years of diversified experience as a wealth transfer strategist with an extensive background in recommending and implementing advantageous tax strategies for multi-generational wealth families, owners of closely-held businesses, and high-net-worth individuals including complex trust and estate planning. Joy provides clients with wealth transfer strategy planning to accomplish estate and business succession goals. She also performs tax compliance including gift tax, estate tax, and income tax returns for trusts and estates as well as consulting services related to generation skipping including transfer tax planning, asset protection, life insurance structuring, and post-mortem planning. Joy presents at numerous events on topics relevant to wealth transfer strategists including engagements for the ABA Real Property, Trust, and Estate Law Section; Wealth Management Magazine; the Estate Planning Council of Northern New Jersey; and the Society of Financial Service Professionals. Joy has authored and co-authored articles for the Tax Management Estates, Gifts, and Trusts (BNA) Journal; Leimberg Information Services, Inc. (LISI); and Estate Planning Review The CCH Journal, among others, on a variety of topics including wealth transfer strategies, income taxation of trusts and estates, and business succession planning. Joy recently co-authored a book on the new tax reform law.

Table of Contents

PRACTICAL PARTNERSHIP PANACEAS TO COMMON CLIENT CIRCUMSTANCES

- Investment Company Rules Sec. 721
- Eliminating Partnership Valuation Discounts
- Divorce After Creation of Non-Reciprocal SLATs – Partnership Solution

Sale to Grantor Trust for Note – Improving Tax Results

Maximizing Basis Under 1014

Staggering Distributions With No Section 754 Elections

Eliminating Valuation Discounts on Pre-Existing Partnerships

Tax Free Exchanges of Property

Marketable Securities, Private Equity, Venture Capital

Avoiding Gain Upon the Death of Grantor

MODERN ESTATE ADMINISTRATION

General Estate Administration Tips

Does Asset Use or Loans Carry Out DNI?

Trust Tax Distributions

Basis Consistency

Alternate Valuation Date

Debts of Estate – 2053 Proposed Regs

QTIP Planning – General

QTIP Planning – Aggregation Issue

Funding Marital Bequests

Funding Marital Bequests – Discounted Assets

2519 and QTIP

Bypass Trust Not Funded

Portability

Transferee Liability for Estate Tax

DRAFTING FLEXIBLE GRATS

GRATs

Basics

GRAT Requirements

Qualified Interest

Requirements for a Qualified Annuity

Required Trust Terms

Using Hard to Value Assets

Goal of Using a GRAT

Recent Issues with GRATs

Drafting Remedies to Resolve Potential Issues

GRAT Planning Considerations

Proposals to Kill GRATs

Effect of Anti-Grantor Trust Rules

Using Formulas

What is the Benefit of Using a Formula?

What About Timely Payments?

How To Qualify for A Marital Deduction

Benefits of Drafting Transferable Annuity Payments

Benefits of Drafting a Vested Remainder Interest

Myths About GRATs

GRATs Can Fail Even If Average Performance Exceeds the Section 7520 Rate

Inconsistent Performance Is Also a Problem

Steeply Declining GRATs May Work Better

Can You Use Debt with a GRAT?

Structuring GRATs to Improve Performance

Using a Substitution Power

Rolling GRATs and Asset Splitting GRATs

99 Year GRAT

Leveraged GRATs

Split Purchase Annuity Trust

Note: items notated as “comments” are from the authors and not the speakers.

NOTES:

PRACTICAL PARTNERSHIP PANACEAS TO COMMON CLIENT CIRCUMSTANCES

Presenter: Paul Lee is the Chief Tax Strategist at Northern Trust Company.

Investment Company Rules Sec. 721

- Watch funding of partnerships with marketable securities. The partners may need to have identical securities positions to avoid investment company rules. If they fail the mechanical tests so that the partnership portfolio is deemed to be a diversification, deferred gain could be triggered.

- Comment: The investment company rules are not intuitive and general definitions of "diversification" are not relevant. There are specific mechanical tests that have to be monitored before any investment partnership is funded. It could be a good idea to review the rules prior to engaging in these transactions.

Eliminating Partnership Valuation Discounts

- Most taxpayers never face an estate tax. Valuation discounts may thus prove detrimental. Example: Decedent owns a 25% limited partnership interest in real property with a gross value of $20M. To the extent that the fair market value of the decedent's interest is determined by applying valuation discounts, the basis step up will be limited. The IRS may even argue for valuation discounts to limit basis adjustment at death.

Consider the following potential opportunity that might avoid valuation discounts and potentially allow for a greater basis step-up:

- State default rules often provide that any restriction in limited partnership ("LP") agreement is permissible as a matter of state law. General partnership ("GP") statutes are fairly standard across the states. GP law provides that a general partner can leave the GP at anytime in exchange for the greater of their liquidation value or the fair market value (FMV) of their interest. So, if the LP were converted into a GP, each individual would own a GP interest which would not be subject to the same restrictions and therefore have a higher FMV than LP interests. While converting an LP to a GP would accomplish a greater step-up, it would also subject the owner to personal liability for all of the entity debts and claims.

- In lieu of giving up limited liability, each LP owner might instead transfer their interest to a single member limited liability company ("SMLLC"). Then, each SMLLC can join together to form a GP. Using this structure may reduce or eliminate discounts without requiring owners to give up limited liability.

- Comment: There are different views as to whether the language in the governing instrument might be used to support the elimination of discounts. Some suggest that approach might trigger some type of gift based on theory of CCA 202353018. Others disagree. See Steve Akers outline from this year at page 50: "have a shareholder agreement that will eliminate the discount (by giving the marital legatee the right to liquidate the company or otherwise have control)."

- Comment: Research state law to be certain that under applicable state law each single member disregarded LLC will have charging order and asset protection benefits similar to that provided by a multi-member partnership. If not, have the client weigh the possible benefit of reducing or eliminating discounts versus the potential reduction in, or loss of, liability protection. Alternatively, it may be feasible to create the structure in a state where this is feasible.

- Comment: Depending on the nature of the assets of the entity, it is possible that determining fair market value might still require some application of valuation discounts, notwithstanding changes to the entity structure. For example, for real estate, there may still be a material partition discount. For example, in the *Estate of LeFrak* (1993), the court held that the determination of a fractional interest discount must consider the cost, uncertainty and delays attendant upon partition proceedings as the basis to allow a fractional interest discount. The Court in *LeFrak* found a 30% valuation discount.

Divorce After Creation of Non-Reciprocal SLATs – Partnership Solution

- It is common for married couples to create non-reciprocal spousal lifetime access trusts (SLATs). Assume that each SLAT is funded with different assets and that one SLAT is worth $10M and the second SLAT is worth $14M, so that the larger SLAT has $4M more than the other at the time of divorce. Might a partnership plan overlay help the couple negotiate a divorce settlement?

    - Consider the following idea:

- After SLAT funding husband and wife divorce. There is a different value in each as well as different assets. Perhaps different tax profiles. How can this be addressed? During the negotiations the trustee of the larger SLAT modifies and divides that SLAT into two SLATs (by decanting, trustee action, etc.) so that there is the resulting trust which has $4M (and may only benefit descendants), and the other SLAT will have $10M, so that the two SLATs have equal $10M each, identical asset values, although the assets still remain different.

- Effectively, the larger SLAT was divided to slice off the excess value into a separate new trust. Then the spouse could renounce his or her interests in that SLAT so that it will only benefit say children or other heirs.

- Comment: This presumes that spouses on the verge of divorce might be willing to give up rights to the potential benefits of trust assets in order to cooperate with each other. For those couples who can work together to implement this strategy, this technique may solve some otherwise intractable matrimonial issues.

- So far, we have equalized the value of the two SLATs. But the assets and tax profiles are still different. That will be addressed next.

- ave each SLAT put the assets it has into a partnership. Each SLAT will own ½ of the assets of the partnership. Both SLATs must be grantor trust as to all income and principal, e.g., by a swap power. Then you end up with each SLAT having a 50% interest in each asset.

- For 704(c) purposes each spouse is deemed to have put in exactly ½ of each asset. So, since 50/50 partnership, the income tax results will be identical to each SLAT and spouse. Provide for tax distributions each year to each spouse.

- Comment: Combining both SLAT assets into a partnership can address the equalization of income and rates of return. However, will this require more coordination and involvement of the soon to be ex-spouses? Is that a problem? Might an independent general partner (or manager if LLCs are used) resolve that?

- Comment: This plan does not address what might be fundamental and economically significant differences of each SLAT from the other. If that is the case, and those differences are somehow addressable, this approach may face a further impediment. In order to make the trusts distinguishable for purposes of the reciprocal trust doctrine practitioners often build in an array of differences. One SLAT may provide the spouse/beneficiary a 5/5 power and a HEMS standard for distribution during lifetime. The other spouse's SLAT may have neither. The result might be that even if the assets are identical the ability of each spouse to reach and benefit from the SLAT's assets and income may be very different.

- Grantor trust status. Each SLAT (created for the other spouse) is by definition a grantor trust as to the settlor spouse. That means post-divorce the settlor spouse will remain liable on the income earned by the SLAT that they may not be a beneficiary of and which income may be paid to their ex-spouse.

- One solution is to structure or modify the trusts so that the income distributions of the SLAT to the spouse/beneficiary is subject to approval by an adverse party. That will make the SLAT a spousal lifetime access non-grantor trust or (SLANT) so that this income tax issue will be avoided. Some believe that there is some risk in this approach, in part because of the difficulties in defining who constitutes an "adverse party."

- Comment: Many practitioners frequently use the adverse party technique and believe that there is reasonable support for that position despite the uncertainties that must be acknowledged. Lots of different views.

Sale to Grantor Trust for Note – Improving Tax Results

- Settlor sells appreciated asset to a grantor trust (IDIT – Intentionally Defective Irrevocable Trust) for a note. The IDIT collateralizes the note. You may trigger gain on death. How can you address this problem? Using partnership planning.

- The IDIT and the grantor contribute to an LLC all that they own. Grantor contributes assets including the note due to him from the grantor trust. The IDIT contributes property it owns, subject to the note.

- So, in the new LLC which is disregarded since the grantor and a grantor trust are viewed as a single taxpayer, the result is that the debt and note are held by the same entity/person. Even though the LLC is disregarded for income tax purposes it is respected for state law purposes. So, under state law the note and the debt merge and disappear.

- If the debt disappears under state law there can be no gain triggered.

Maximizing Basis Under 1014

- When an interest in a partnership is included in the gross estate of a decedent, the partnership will often make a section 754 election (or already have one in place) and rely upon the inside basis adjustment under section 743(b) to "step-up" the basis of the assets inside the partnership. There are reasons to do so; however, the inside basis adjustment and the how it is allocated to each of the partnership assets under section 755 of the Code is formulaic and there are other strategies that may be more tax efficient.

- The proposed alternative strategy works best with marketable securities.

- A distribution of marketable securities is generally treated as a distribution of cash (rather than property).

- Unless an exception applies, a distribution of marketable securities results in gain to the distributee partner, the gain is the excess of the value of the marketable securities over the partner's outside basis.

- The amount of marketable securities treated as cash is reduced (and the potential recognized gain is reduced) by, according to the section 731(c)(3)(B) of the Code:

  - such partner's distributive share of the net gain which would be recognized if all of the marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, over (ii) such partner's distributive share of the net gain which is attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under clause (i)

Staggering Distributions With No Section 754 Elections

- When a decedent's partnership interest is included in the gross estate, the estate will often claim a valuation discount for lack of marketability and control. This is often the case with estates when estate tax is payable (i.e., the gross estate exceeds the decedent's Applicable Exclusion Amount and there is no ability to "zero-out" the estate tax with the marital deduction because there is no surviving spouse). The valuation discount represents a 40% Federal estate tax savings, which is typically greater than the income tax savings from a basis adjustment under section 1014 of the Code (i.e., 20% for capital assets and 37% for ordinary income assets). As a result, the "step-up" in basis to the partnership interest is reduced by the valuation discount, which in turn, reduces the inside basis adjustment under section 743(b), if the partnership has a section 754 election in place.

- Example:

  - A and B form AB Partnership. A contributes shares of a publicly-traded company Z (Stock Z), which have a fair market value of $10 million and an adjusted basis of zero, in exchange for a 50% interest in AB Partnership. B contributes Stock Z shares, which have a fair market value of $10 million and an adjusted basis of $4 million, in exchange for a 50% interest in AB Partnership. Although AB Partnership would be considered an "investment company" under sections 721(b) and 351(e), the

contributions to the partnership does not result in diversification. Thus, the contribution does not result in gain recognition and under section 721(a), A receives a partnership interest that has an outside basis of zero and a capital account of $10 million. B receives a partnership interest that has an outside basis of $4 million and a capital account of $10 million.

- Soon thereafter, A passes away. On date of death, the value of Stock Z has not changed. The fair market value of A's partnerships interest is appraised at $7 million, due to a 30% valuation discount. The partnership makes a section 754 election to make a corresponding inside basis adjustment under section 743(b) to the assets in the partnership.

    - Under section 743(b)(1), A's estate (the transferee) is entitled to an increase in partnership inside basis equal to the "excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property." The estate's basis in the partnership interest, under section 1014, is "the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent." As a result, since there are no liabilities or IRD in this example, the estate's basis in the partnership interest is $7 million.

    - A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities. There are no partnership liabilities. The partner's previously taxed capital, in this example, is the amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets, decreased by the amount of tax gain that would be allocated to the partner on the hypothetical transaction. The amount the estate would receive in the hypothetical sale, in this example, is $10 million (A's capital account balance at death), and the amount of gain that would be allocated to the estate is $10 million. The latter is due to the fact that A contributed shares of Stock Z when it was (and still is) worth $10 million, and under section 704(c), all of that gain must be allocated to A's estate, as transferee. The hypothetical gain attributable to the other assets (the shares of Stock Z

contributed by B) in the partnership are allocated to B under section 704(c). As a result, the estate's previously taxed capital (and proportionate share of the adjusted basis of the partnership property) is zero ($10 million minus $10 million). The excess of the basis to the estate (the transferee) is $7 million ($7 million minus zero), As a result, under section 743(b)(1), the increase in inside basis is equal to $7 million.

▪ The positive $7 million inside basis adjustment under section 743(b) will be allocated to the partnership assets according to section 755. All of the assets in this example are capital assets, so the entire basis adjustment is allocated to that class. In this simple example, only the property contributed by A would result in gain to the estate (transferee) due to the section 704(c) rules. As a result, the entire $7 million inside basis adjustment would be applied to the Stock Z contributed by A, and none would be applied to the Stock Z contributed by B. As a result, the Stock Z contributed by A has an inside basis of $7 million and a fair market value of $10 million.

Eliminating Valuation Discounts on Pre-Existing Partnerships

- A common "free-base" situation occurs when the first spouse passes away, and assets are transferred to or for the benefit of the spouse in a transfer that qualifies for the marital deduction under section 2056. In community property states, as mentioned above, the "step-up" in basis will also apply to the assets held by the surviving spouse. Clearly, for income tax purposes, a higher valuation is preferable to a lower valuation. As such, consideration should be given to when valuation discounts should be created and when they should be removed. For example, when both spouses are alive, it is sensible to avoid valuation discounts, and if the assets that would be includible in the surviving spouse's estate are significantly above the Basic Exclusion Amount (including any ported amount), then valuation discounts may save more in estate taxes than the income tax savings from the subsequent "step-up" at the surviving spouse's estate. If a quick succession of deaths is a worry, practitioners could be prepared to layer valuation discounts immediately after the first death, so post-mortem estate planning might include the estate creating family limited partnerships prior to the complete settlement of the estate. Comment: Watch the proposed 2053 Regs.

- Where assets have been divided among generations to create discounts, consideration could be given to undoing those arrangements if the effect is to depress the value of an estate below the amount of BEA in order to increase the income tax basis of the assets under section 1014.

- Family limited partnerships or other entities that create valuation discounts could be dissolved or restated to allow the parties to the entity to withdraw for fair value or to remove restrictions on transferability.

Tax Free Exchanges of Property

- As discussed in these materials, contributions of property in exchange for an interest in a partnership are generally non-recognition events. In addition, distributions of partnership property to partners are also generally nontaxable. Before the “anti-mixing bowl” rules were enacted, taxpayers would use partnerships as a vehicle to exchange assets and property interests without recognizing any gain. Of course, taxpayers can gift property to each other with little to no income tax consequences, but the transfers may carry gift tax consequences and the IRS might recast related transfers as recognition events.

- Partnerships are one of the only vehicles in the Code that will allow taxpayers to exchange property interests in a tax free manner. For such strategies to work, taxpayers need to have patience because the “anti-mixing bowl” rules have a 7-year holding period in order avoid recognition caused by the distribution of partnership property to a contributing partner or to a non-contributing partner. For this reason, it is often recommended that taxpayers fund partnerships as soon as possible to start the holding period for “mixing bowl” purposes and to keep the assets in the partnership unless there is a compelling tax reason to distribute the property.

- Avoiding the Mixing Bowl Rules – example. Partners A, B, and C form ABC Partnerships. Under section 721, the partners make the following contributions of non-depreciable capital assets, at three different times but in the same year: (i) Partner A contributes Asset A, which has an adjusted basis of $0x and fair market value of $100x; (ii) Partner B contributes Asset B, which has an adjusted 248 Exchanges between grantor’s and IDGTs are income tax free, so are most transfers from non-grantor trusts to beneficiaries. These vehicles, however, often involve transfers that are taxable gifts or have the same effect of a taxable gift like an installment sale to an IDGT (which transfer appreciation out of the grantor’s gross estate). 3-51 basis of $20x and fair market value of $100x; and (iii) Partner C contributes Asset C, which has an adjusted basis of $50x and fair market value of $100x. More than seven years after the last contribution, the ABC Partnership liquidates and makes the following liquidating distributions: (i) Asset C to Partner A; (ii) Asset A to Partner C; and (iii) Asset B to Partner C. Because the liquidating distributions occur more than seven years after the last contribution of the partners, there is no “mixing bowl” transaction and the distributions are tax free. In addition, the adjusted bases of the assets

held by the former partners are as follows: (i) Asset C held by A has an adjusted basis of $0x; (ii) Asset A held by B has an adjusted basis of $20x; and (iii) Asset B held by C has an adjusted basis of $50x. As a result, A, B, and C have accomplished a tax free exchange properties, and the tax basis that each had with their original property is now reflected in the property that they received.

- Swapping Interests in Different Properties – Example. After the death of their parents, siblings, A, B, and C. find themselves equal partners in three different partnerships that own rental real estate in different parts of the United States, as follows: (i) Partnership 1 holds rental property in California (CA Property) with a fair market value of $300x and an adjusted basis of zero. Each of the siblings has a 1/3 interest in Partnership 1, and each of their partnership interests have an outside basis of zero and a capital account of $100x. The parents contributed the CA Property to the partnership 10 years ago. (ii) Partnership 2 holds rental property in New York (NY Property) with a fair market value of $330x and an adjusted basis of zero. Each of the siblings has a 1/3 interest in Partnership 2, and each of their partnership interests have an outside basis of zero and a capital account of $110x. The parents contributed the NY Property to the partnership 15 years ago. (iii) Partnership 3 holds rental property in Florida (FL Property) with a fair market value of $300x and an adjusted basis of zero. Each of the siblings has a 1/3 interest in Partnership 3, and each of their partnership interests have an outside basis of zero and a capital account of $100x. The parents contributed the FL Property to the partnership 5 years ago. Each year, all three of the partnerships distribute 100% of the net rental income to the partners. Partner A is a resident of California, but Partner A must file and pay income taxes in A's resident state of California and also New York. Partner B is a resident of New York, but Partner B must file and pay income taxes in B's resident state of New York and also California. Partner C is a resident of Florida, but Partner C, a resident of a state that has no state income tax, must file and pay income taxes in both California and New York. Partners A, B, and C wish to exchange their 1/3 interests in each of the rental properties in a manner that results in the following: (i) Partner A will own 100% of the CA Property; (ii) Partner B will own 100% of the NY Property; and (iii) Partner C will own 100% of the FL Property. They wish to accomplish the foregoing in an income tax free manner (or in the most tax efficient way) and without making (or being deemed to have made) taxable gifts to each other.

- Common Mistake – example. Under section 721: (i) Partnership 1 contributes the CA Property to newly-created Partnership 4 in a tax free exchange for a partnership interest in Partnership 4; (ii) Partnership 2 contributes the NY Property to newly-created Partnership 4 in a tax free exchange for a partnership interest in Partnership 4; and (iii) Partnership 1 contributes the FL Property to

newly-created Partnership 4 in a tax free exchange for a partnership interest in Partnership 4. Partnership 4 owns all of the rental real estate. The net effect, even if Partnerships 1, 2, and 3 remain in existence or liquidate (distributing partnership interests in Partnership 4 to the partners), is Partners A, B, and C will own a 1/3 interest in each of the rental properties. Unfortunately, the contribution to a newly-created Partnership 4 (whether or not Partnership 1, 2, and 3 remaining in existence) will restart the holding period for “mixing bowl” purposes. This means the partners will need to wait an additional 7 years before the properties can be exchanged in a tax free manner, notwithstanding the fact that the properties have been held in a partnership for a minimum of 5 years.

- A better solution might be to merge the partnerships and their respective properties into one partnership that is deemed to be a continuation of all of the partnerships. The Code provides a methodology to merge partnerships, the challenge is to ensure that the merger is a nontaxable event and does not restart the holding period of any of the properties for “mixing bowl” purposes. Use Assets-Over Merger into Existing Partnership.

- With an assets-over merger, the merged partnership’s contribution of 704(c) property to the resulting partnership in exchange for an interest in the resulting partnership under section 721 and the liquidating distribution of the resulting partnership interest to the partners of the merged partnership will not trigger section 704(c)(1)(B). However, a subsequent distribution of the section 704(c) property by the resulting partnership will however be subject to section 704(c)(1)(B).

- Example (cont.) - Instead of creating a newly-created partnership, Partnerships 1 and 3 contribute all of their assets (CA and FL Properties) and liabilities (none) to Partnership 2 under section 721, in exchange for interests in Partnership 2. Immediately thereafter, Partnerships 1 and 3 distribute their interests in Partnership 2 to A, B, and C, in full liquidation and termination of Partnerships 1 and 3. Partnership 2 now owns the CA, NY, and FL Properties, A, B, and C are equal partners, and each of them has a 1/3 interest in Partnership 2, each having $0x of outside basis and a capital account balance of $310x (the sum of all their capital account balances in all three of the partnerships before the merger). As discussed above, this is an “assets-over” merger of Partnerships 1 and 3 (the terminating or consolidating partnerships) into Partnership 2 (the resulting partnership). For “mixing bowl” purposes, the merger is nontaxable. For holding period purposes, Partnerships 1 and 3 are deemed to continue through Partnership 2. As a result, Properties A, B, and C are deemed

to have been contributed to Partnership 2, ten, fifteen, and five years, respectively.

- (i) adjusted basis of zero); (ii) $2 million of growth equities with an adjusted basis of $1 million; (iii) $5 million of private equity investments with an adjusted basis of $5 million; and (iv) $2 million of high dividend paying equities with an adjusted basis of $1 million. For income tax purposes Spouse A is deemed to own all of the assets of SLAT B, and Spouse B is deemed to own all of the assets of SLAT A. As a result, this exchange of assets will not be a taxable event under section 1041, and the SLATs will have carryover basis. This exchange can happen prior to the divorce when A and B are still married or the transfers can occur "incident to the divorce" (within one year after the date on which the marriage ceases or related to the cessation of the marriage).