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THEY SET IT UP, BUT YOU HAVE TO RUN IT; THE CARE AND HANDLING OF FLPS

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I. Introduction

A. The Family Limited Partnership ("FLP") is not a transfer tax reduction technique for families, but a tremendously useful planning tool that can be used to accomplish multiple estate, business, and family planning objectives, including:

1. asset protection [to both protect assets in the FLP from liabilities outside the FLP (malpractice judgments, etc.) and/or to limit satisfaction of liabilities from assets in the FLP to those assets and thus protect assets outside of the FLP from the reach of those liabilities];

2. transfer tax discounts;

3. preservation of capital;

4. reduction of administrative costs;

5. simplify annual exclusion gifting for assets that are difficult to divide or transfer (e.g. real estate with attendant property tax obligation, closely held equity interests, etc.);

6. unification of fractional interests in real estate;

7. preservation of character of property as separate property for descendants;

8. transfer equity in assets to heirs without yielding control of the asset or income to the heirs (or, in the case of a trust for the heirs, a third party trustee);

9. succession for management of assets in event of death of managing partner;

10. probate avoidance;

11. protect family assets from transfer outside the family through divorce or otherwise;

12. consolidation of investment assets of parties to allow for greater diversification and/or access to investment managers (i.e., to meet minimum dollar limits);

13. facilitate communication/education amongst family members with regard to money/asset management styles, responsibilities, and techniques; and

14. mandatory arbitration of disputes.

Though one or more of these benefits may be promised to the client upon the establishment of the FLP, the achievement of each individual benefit (in addition to the avoidance of tax and non-tax traps along the way) requires a diligent, continuous effort on multiple fronts both at the formation stage of the partnership but also on an annual basis during the operating years and upon termination.

B. From a transfer tax planning perspective, the FLP is a valuable planning tool because it allows clients to transfer limited partnership interests (as opposed to ownership of the underlying assets) to succeeding generations and in doing so, due to the nature of the limited partnership interest, accomplish both tax and non-tax objectives. In today's transfer tax world, with a "frozen" $1,000,000 gift tax exemption and the far reaching impact that that reality has on all elements of gift planning, the use of discounted limited partnership interests allows the planner to leverage the gift tax exemption, GST exemption, and the annual gift tax exclusion. In addition, the use of limited partnership interests in conjunction with other estate planning tools (i.e., intentionally defective grantor trust, grantor retained annuity trust, self-cancelling installment notes, private annuities, etc.) can greatly enhance the overall value of those planning techniques.

II. Transfer Tax Planning Update

A. The FLP area that has received the most attention recently involves the Federal Estate Tax impact of the creation and operation of a FLP in a family context and, more specifically, the application of Section 2036 to require the inclusion of FLP assets in the taxable estate of a contributing partner. That attention has evolved into developments that have significantly impacted the planning and operating steps necessary to assure that the transfer tax objectives set out to the client are accomplished. Despite the IRS challenges and Tax Court/District Court opinions, the FLP continues to be a viable planning tool provided that it is formed, structured, and operated correctly.

B. In *Kimbell v. U.S.*, 244 F. Supp 2d 700 (January 14, 2003, amended April 16, 2003) vacated and remanded, *Kimbell v. U.S.*, 371 F.3d 257 (5^{th} Cir., 2004), the Fifth Circuit follows a two-part test to determine whether the bona fide sale exception to Section 2036(a) applies:

1. Was the transaction a bona fide sale?

2. Was there adequate and full consideration?

C. In addressing whether the "full and adequate consideration" test was satisfied with respect to the transfer of assets in exchange for a partnership interest, the Fifth Circuit set forth a three-part test in *Kimbell:*

1. Were the interests credited to each of the partners proportionate to the fair market value of the assets each partner contributed to the partnership?

2. Were the assets contributed by each partner to the partnership properly credited to the respective capital accounts of the partners?

3. On termination or dissolution of the partnership, were the partners entitled to distributions from the partnership in amounts equal to their respective capital accounts?

D. If these three requirements are met, then the taxpayer has received full and adequate consideration for a transfer of property. The inquiry then turns to whether or not the transaction was bona fide. In *Kimbell*, the Fifth Circuit then reviewed a number of factors which were unchallenged by the IRS which indicate that the transaction was bona fide:

1. The decedent retained sufficient assets outside of the partnership to meet living expenses;

2. There was no commingling of the decedent's assets with those of the partnership;

3. The partnership formalities were followed;

4. The assets were actually assigned to the partnership;

5. The assets contributed to the partnership included working interests in oil and gas properties which required active management;

6. The decedent's estate advanced several credible non-tax business reasons as to why the partnership was formed which could not be accomplished with the decedent's trust.

E. *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000) aff'd in part, rev'd in part, *Estate of Strangi v. Commissioner* 293 Fed 3rd 279 (5th Cir., 2002), on remand *Estate of Strangi v. Commissioner*, T.C. Memo 2003-149 (May 20, 2003) aff'd, *Strangi v. Commissioner*, 417 F3d 468, (5th Cir., 2005) was decided in late 2005. From a substantive legal standpoint, *Strangi* further explained that for a sale to be bona fide, there must be an objective and substantial business or other non-tax purpose for forming the partnership. Note that the court did not focus on the subjective mind set of the decedent or whether the decedent subjectively intended to save estate taxes by forming the partnership. Rather, the court focused on whether an objective non-tax business reason existed for the formation of the partnership.

III. Formation and Operation

The key to achieving the specific objectives for which the FLP is established is to assure that it is formed and operated with a proper respect for (1) the fact that the FLP is a separate legal entity apart from the partners, (2) the written formation and operation rules under the applicable state law and the partnership agreement, and (3) the rules that have been developed with respect to the areas and issues that the FLP is designed to address (i.e., creditor protection laws, federal transfer tax laws, etc.). From that starting point, there evolves a series of both technical and common sense based rules that should be followed in forming and operating a FLP. As evidenced by the preceding discussion with respect to transfer tax laws, the list of do's and don'ts is constantly evolving and changing. Some of the current rules are outlined below.

A. In Forming a FLP:

1. Remember to identify and document the objective and substantial non-tax business motivations for the formation of the partnership;

2. Do not transfer substantially all of the taxpayer's assets into a FLP;

3. Try to avoid deathbed transfers;

4. Have other family members or other family entities, such as trusts, make contributions to the FLP in exchange for partnership interests;

5. Avoid transferring personal use assets into the FLP;

6. Observe (and document the observance of) all state filing and entity organization requirements;

7. Assure that each partner’s capital account balance, percentage ownership interest, and rights with respect to distributions reflects the fair market value of the assets that such partner contributed to the partnership;

8. Assure that the actual contribution of the assets to the FLP by a partner is documented (i.e., deed, assignment form, etc.) and that the actual date of the transfer coincides with the date that he or she becomes a partner;

9. Take care to use business-like means to value each contributed asset and document that valuation methodology;

10. Title all FLP assets in the name of the FLP (real estate, bank accounts, investment accounts, notes, accounts receivable, etc.) and do not commingle FLP assets with any assets of partners or others;

11. Do not waive the fiduciary duty of the general partner to the partnership or the other partners;

12. Require that either unanimous consent or some other percentage of partnership interests in excess of the client’s ownership is necessary in order to remove and replace a general partner; and

13. Assure that the partnership agreement (and all other formation documents) is drafted so that its provisions are consistent with all these (and any other) formation and operating rules (e.g. require distributions to be prorata and tied to partnership-related criteria instead of partner needs).

B. In Operating a FLP:

1. Make distributions prorata to all the partners;

2. Do not pay personal expenses of a partner with FLP funds;

3. If a partner or party related to a partner uses partnership assets, assure that the transaction is conducted on a third-party, arms-length basis, including fair market value payment for such use and proper documentation of all elements of the transaction (i.e., the use of partnership assets by a partner should include a lease agreement calling for a fair market value rental amount and that rental amount should actually be paid in accordance with the terms of the lease agreement);

4. Avoid having the timing and amount of partnership distributions coincide with the cash flow needs of the founding/donor partner (a pattern of on-going distributions to cover personal expenditures is evidence of an implied retained right to the use of partnership assets);

5. Observe all operating formalities as required under state law and the partnership agreement (meetings, management/voting, distributions, etc.);

6. The general partner, partnership manager, or officers should, in that capacity, actively manage the FLP assets;

7. Where appropriate, document negotiations among the partners as to formation and operation issues (e.g., letters or other correspondence or meeting notes documenting negotiations between the partners with respect to a proposed non-prorata contribution of additional assets by a partner, outlining the parties discussions with respect to how they will set the value of those assets and how such contribution will be reflected through adjustments to the partners capital account balances and percentage ownership interests); and

8. Do not pay estate taxes on the estate of a partner with partnership assets.

IV. Income Tax Issues Related to Formation

A. <u>Contribution of Appreciated Assets</u>.

1. <u>Nonrecognition</u>. Under the rules of Section 721, a contribution of property to a partnership is viewed as a change in the form of ownership of the property and does not result in recognition of immediate taxable gain or loss to either the contributing partner or the partnership. This is true even when the fair market value of the property at the time of its contribution differs from the contributing partner's income tax basis.

2. <u>Basis in Partnership Interest</u>. Section 722 provides that the contributing partner's basis in his partnership interest will be equal to his adjusted basis in the assets contributed to the partnership reduced by any cash distributed to the contributing partner or deemed distributed to the contributing partner in the event the contributed property is encumbered by liabilities.

3. <u>Partnership's Basis in Contributed Assets</u>. Section 723 provides that the partnership will take a carry-over basis in the assets contributed by the contributing partner.

B. <u>Partnership Investment Companies</u>. Section 721(b) provides an exception to nonrecognition treatment that was created for taxpayers who contribute appreciated property to a partnership which meets the definition of an <u>investment company</u>. This exception was created to prevent a taxpayer from achieving a tax-free diversification of an investment portfolio. Typically the contributing partner would contribute a concentrated holding of a small number of securities to a partnership that pooled the holdings of several taxpayers. This would allow the contributing partner to diversify his portfolio through his ownership in the partnership while taking advantage of Section 721's taxable gain deferment.

1. <u>Definition of Investment Company</u>. Section 721(b) does not define an investment company but incorporates the definition of an investment company used in the subchapter C rules. The rules related to corporations are contained in Section 351. Under Section 351(e)(1), a corporation meets the definition of an investment company if more than 80% of the value of its assets are cash, stocks, and certain other securities.

2. Insignificant Nonidentical Assets. The transfer of certain nonidentical assets is disregarded if the cash, stocks, or securities are insignificant in size to the other assets transferred. Treas. Reg. § 1.351-1(c)(5). The Regulations provide an example in which $200 worth of one stock is considered insignificant in relation to $19,000 worth of another stock. Treas. Reg. § 1.351-1(c)(6), Example (1). The IRS has also ruled that cash amounting to less than 1% of the total assets transferred to a partnership was insignificant in PLR 9345047 and a non-identical asset worth less than 5% of the total assets transferred was insignificant in PLR 20000608.

3. Exception for Diversified Portfolio. Even if a partnership is classified as an investment company, gain is not recognized if the transfer does not result in diversification of the contributing partner's portfolio. Essentially, diversification occurs if other partners contribute different assets to the same partnership. The regulations also provide that a contribution of an investment portfolio which is already diverse will not trigger gain to the contributing partner because the goal of the investment company rules is to prevent diversification. If diversification already exists when the assets are contributed, then no gain must be recognized upon the contribution.

a. Definition of Diversified Portfolio. Section 368(a)(2)(F)(ii) provides that a portfolio is diversified if (i) not more than 25% of the assets are invested in one issuer and (ii) not more than 50% are invested in five or fewer issuers. Section 368(a)(2)(F)(iv) provides that government securities are included in the total assets for purposes of computing the denominator in the 25%/50% test, but are not treated as securities of an issuer for purposes of computing the numerator. Additionally, under Section 368(a)(2)(F)(iii) there is a look-through rule for investments in mutual funds or other pass-through entities for purposes of the 25%/50% test.

4. Planning with Investment Companies. Once the partnership is classified as an investment company, the transfer of any appreciated property is not eligible for nonrecognition treatment under Section 721. Because loss is not recognized on the transfer, the gain recognized can exceed the net gain realized and the value of the partnership interest received. Therefore, it is better for the contributing partner to sell loss assets and recognize the loss immediately rather than contribute the loss assets to the partnership, in which case a loss will not be recognized until the partnership disposes of the assets in a taxable transaction.

5. Planning to Avoid Investment Company Status. Because a mechanical 80% test is used to determine whether or not an investment company exists, the best way to avoid the investment company classification is to contribute assets such as real estate or mineral interests, which are outside of the definition of marketable securities, so that more than 20% of the assets held by the partnership are not readily marketable stocks or securities.

V. Issues Related to Distributions

A. General Rule. Section 731 provides the general rule for the income tax effect of distributions from a partnership to a partner.

1. Money. Under Section 731(a), money and/or marketable securities which are treated as money under Section 731(c) may be distributed to the distributee partner tax-free to the extent of the distributee partner's adjusted basis in his partnership interest immediately prior to the distribution.

2. **Property Other than Money**. Subject to certain exceptions discussed below, distributions of property other than money to a distributee partner are tax-free to the distributee partner.

3. **Basis of Property Distributed in Nonliquidating Distribution**. Under Section 732(a)(1), the distributee partner's basis in the property distributed will be the partnership's adjusted basis in the property at the time of the distribution. However, Section 732(a)(2) provides that if the distributee partner's basis in his partnership interest is less than the adjusted basis of the property distributed, then the basis of the distributed property in the hands of the distributee partner is stepped down to his basis in his partnership interest.

4. **Basis of Property Distributed in Liquidation of Partner's Interest**. Section 732(d) provides that if the distribution of property to the distributee partner is a distribution in liquidation of his partnership interest, then the basis of the property distributed shall be equal to the distributee partner's basis in his partnership interest reduced by any money distributed to the distributee partner as part of the liquidation.

B. Section 704(c).

1. **Allocation of Gain or Loss**. Section 704(c)(1)(A) requires that a partner who contributes property with built-in gain or built-in loss to a partnership be allocated that built-in gain or loss upon the disposition of the property by the partnership. Section 704(c)(1)(B) requires the contributing partner to recognize gain or loss if the contributed property is distributed to another partner within seven (7) years of the contribution. The contributing partner must recognize gain or loss equal to the gain or loss the partner would have been allocated under Section 704(c)(1)(A) on a sale of the property by the partnership at its fair market value at the time of the distribution.

2. **Like-Kind Property Exception**. Section 704(c)(2) provides an exception for distributions of certain like-kind property. The exception applies if the like-kind property is distributed to the contributing partner not later than the earlier of (i) 180 days from the date of the distribution of the contributed property to the noncontributing partner, or (ii) the due date of the contributing partner's tax return.

3. **Distribution of Pro Rata Portion of Asset**. Treasury Regulation Section 1.704-4(c)(6) provides that Section 704(c)(1)(B) is not applicable to the distribution of an undivided interest in property from a partnership to the extent that the undivided interest is equal to the undivided interest contributed by the distributee partner.

4. **Transferee Rules**.

a. **Built-in Gain Property**. Treasury Regulation Section 1.704-4(d)(2) provides that the transferee of a partnership interest is treated as the contributing partner for purposes of the application of Section 704(c)(1)(B). Therefore, the transferee is considered to step into the shoes of the transferor for purposes of the allocation of the built-in gain.

b. **Built-in Loss Property**. Under the American Jobs Creation Act of 2004, Section 704(c)(1)(C) was added to provide that the built-in loss of contributed property may only be allocated to the contributing partner and not to other partners. Therefore, if a contributing partner transfers a partnership interest or has his partnership interest liquidated, then the built-in loss will be eliminated.

C. **<u>Section 737</u>**. An exception to the general nonrecognition rule with regard to partnership distributions of property, other than money and marketable securities treated as money under Section 731(c), is contained in Section 737. Under Section 737, a distributee partner receiving a distribution of property must recognize gain if the distributee partner contributed appreciated property to the partnership within <u>seven (7)</u> years of the distribution. Section 737 applies to both liquidating and current distributions.

1. **<u>Calculation of Gain</u>**. Gain must be recognized on a distribution to which Section 737 applies to the extent of the <u>lesser</u> of (i) the excess distribution or (ii) the net precontribution gain of the contributing partner.

a. **<u>Excess distribution</u>**. Section 737(a)(1) defines excess distribution as the excess of the fair market value of property, other than money, distributed to the contributing partner over his adjusted basis in his partnership interest, reduced by any money distributed in the same transaction.

b. **<u>Net precontribution gain</u>.** Treasury Regulation Section 1.737-1(b)(1) defines net precontribution gain as the amount of net gain the distributee partner would recognize under Section 704(c)(1)(B) if all of the property in the partnership, immediately before the distribution, that was contributed by the distributee partner in the previous <u>seven (7) years</u> was distributed to another partner, other than a partner who owns more than 50% of the capital or profits of the partnership.

c. **<u>Exclusion for previously contributed property</u>**. Section 737(d)(1) provides that if any of the distributed property consists of property previously contributed to the partnership by the distributee partner, then such property is excluded for purposes of the computation of the excess distribution and the net precontribution gain. Section 737(d)(2) further provides that this exception is not applicable to the extent that Section 751(b) (relating to unrealized receivables or inventory) applies to the distribution.

2. **<u>Transferee Rules</u>**.

a. **<u>Net precontribution gain</u>**. Treasury Regulation Section 1.737-1(c)(2)(iii) provides that a transferee succeeds to the contributing partner’s (transferor’s) net precontribution gain in proportion to the interest transferred.

b. **<u>Previously contributed property</u>**. Section 737 and the Regulations promulgated thereunder are silent on the issue of whether a transferee steps into the shoes of the transferor for purposes of the previously contributed property exception. One can make an argument that because a transferee succeeds to the contributing partner’s net precontribution gain, it should logically follow that the transferee should also step into the shoes of the contributing partner for purposes of the previously contributed property exception. However, in the context of allocating Section 704(c)(1)(B) gain, Treasury Regulation Section 1.704-4(d)(2) specifically provides for a transferee to step into the shoes of the transferor for purposes of Section 704(c)(1)(B) gain. Policy arguments can be made both for and against the applicability to transferees. If you plan to rely upon the “step in the shoes” rule for the previously contributed property exception, be prepared to defend your position in the event of a challenge by the IRS.

D. **Section 731(c)**.

1. General Rule. Section 731(a)(1) provides an exception to the general nonrecognition-of-gain rule applicable to distributions to a partner for distributions of money in excess of the distributee partner's adjusted basis in his partnership interest. Section 731(c) treats the fair market value of marketable securities as money for purposes of Section 731(a)(1). Therefore, the receipt of marketable securities in a distribution will trigger gain recognition by the distributee partner to the extent that the value of the securities exceed the adjusted basis in his partnership interest. To the extent that the value of the securities is treated as money for purposes of Section 731(a)(1), that amount is treated as money for purposes of gain recognition under Section 737 as well.

2. Marketable Securities. Marketable securities are defined by Section 731(c)(2)(A) as financial instruments and foreign currencies which are actively traded on the date of distribution. Financial instruments include stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives.

3. Exceptions to Gain Recognition on Distribution of Marketable Securities.

a. Distribution of Previously Contributed Marketable Securities. No gain is recognized by a partner who receives a distribution of marketable securities contributed by him to a partnership. Section 731(c)(3)(A)(i).

b. Non-Marketable at Time of Acquisition. No gain is recognized if (i) the marketable securities were not marketable at the time they were acquired by the partnership, (ii) the entity to which the security relates has no outstanding marketable securities, (iii) the security is held by the partnership for at least six months before the date the security became marketable, and (iv) the security was distributed within five years of the date on which it became marketable. Section 731(c)(3)(A)(ii); Treas. Reg. §1.731-2(d)(1)(iii).

c. Nonapplicability to Investment Partnerships. Section 731(c) is inapplicable to marketable securities distributed by an investment partnership to an eligible partner as defined by Section 731(c)(3)(C). An investment partnership is a partnership which has never engaged in a trade or business and which has held investment assets. An eligible partner is a partner who contributed only financial assets.

4. Reduction of Gain. Section 731(c)(3)(B) reduces the amount of money deemed received by the distributee partner upon a distribution of marketable securities by the excess of the partner's share of the net gain of the partnership's total marketable securities immediately before the distribution over the partner's share of such gain immediately after the distribution. Therefore, the amount of the distribution that is not treated as money will depend on the partner's share of the net appreciation in all partnership securities. In making this determination, the partner's share of net gain is determined immediately before and after the transaction, using the same fair market value for the securities in each case.

The purpose of Section 731(c)(3)(B) is to allow a partner to receive his portion of the appreciated marketable securities tax-free. A partner will only recognize gain in the case of a non pro rata distribution of marketable securities to the partner where the partnership retains other appreciated assets.

5. **Transferee Rules.** There is no "step in the shoes" rule for the previously contributed marketable securities exception contained in Section 731(c)(3)(A)(i). Both Section 731(c)(3)(A)(i) and Treasury Regulation Section 1.731-2(d)(1) only refer to the nonapplicability of Section 731(c) to distributions of marketability securities to the contributing partner and make no reference to a transferee.

E. Ordering Rules for Gain on Distributions.

If a distribution results in the application of Sections 731(c), 704(c)(1)(B), and 737, then the effect of the distribution is determined by applying Section 704(c)(1)(B) first, then Section 731(c), and finally Section 737.

VI. Section 754 Basis Adjustment

A. **General**. A transfer of an interest in a partnership generally has no effect on the partnership or on the remaining partners. However, in most instances, a taxable transfer will result if a disparity between the transferee partner's adjusted basis in the transferred partnership interest, and his share of the partnership's adjusted basis in its assets, exists. A Section 754 election may eliminate this disparity by adjusting the basis of the partnership assets. The Section 754 election puts the transferee partner in the same tax position as if he had acquired a proportionate share of the partnership assets rather than his partnership interest. A Section 754 election is optional, but it applies to all subsequent transfers and is irrevocable unless IRS consent is obtained.

B. **Substantial Built-In Loss**. The 2004 American Jobs Creation Act mandates a Section 754 election in certain instances. A partnership must adjust the basis of the partnership assets to eliminate any disparity between inside and outside basis if the partnership has a substantial built-in loss immediately after the transfer of the partnership interest. A substantial built-in loss is defined by Section 743(d) as an adjusted basis in partnership property in excess of the property's fair market value by more than $250,000.

C. **Calculation of Basis Adjustment**. Two steps are necessary in determining the basis adjustment. First, the amount of the total basis adjustment is determined under Section 743(b). Then the manner in which the basis adjustment is to be allocated among partnership assets is determined under Section 755.

1. **Section 743(b)**. If the transferee partner's share of basis in partnership assets is less than his basis in his partnership interest, the adjustment is positive. The adjustment is negative for a basis in the partnership interest that exceeds the basis in partnership assets. The transferee partner's basis in his partnership interest is determined under Section 742, while his basis in his share of partnership assets is his interest in the partnership's previously taxed capital plus his share of partnership liabilities. If one or more partners have contributed property in-kind in exchange for an interest in the partnership, the rules of Section 704(c) must be taken into account when determining the amount of the Section 743(b) adjustment.

2. **Section 755.** Once the amount of the basis adjustment is determined, then the rules of Section 755 are applied to the assets within the partnership.

3. **Impact of Valuation Discounts**. If a discount is taken for the valuation of a partnership interest held by a decedent, the amount of any Section 743 adjustment will be affected. In a situation where a partnership has a high inside basis in its assets, a valuation discount applied to a partnership interest may result in a negative basis adjustment to the partnership assets if a Section 754 election is made. In such case, it may be advisable not to make the Section 754 election.

VII. Examples

Example 1: Non Pro Rata Distribution in Liquidation of Partner's Interest

On January 1, 2003, Carol and Mike form a limited partnership by contributing appreciated real estate and stock to the partnership in exchange for 100% of the LP units.[1] Mike and Carol make use of their lifetime gift exemption by making gifts of partnership units in the LP so that each of their three children owns a 20% partnership interest.

On August 1, 2005, the family holds a meeting and everyone is in agreement to develop the real estate except for Greg who favors selling the real estate and purchasing more stock. Greg asks to get out of the partnership because he is not in favor of the development. The other family members agree that it is a prudent idea to redeem his partnership interest in order to preserve family harmony. Greg asks to receive $800,000 of stock from the partnership in exchange for his interest.

	January 1, 2003			August 1, 2005	
	Adjusted Tax Basis	FMV	Pre-Contribution Gain	Adjusted Tax Basis	FMV
Stock	500,000	2,000,000	1,500,000	320,000	1,200,000
Real Estate	400,000	2,000,000	1,600,000	400,000	2,000,000
	900,000	4,000,000	3,100,000	720,000	3,200,000
Mike	180,000	800,000	620,000	180,000	800,000
Carol	180,000	800,000	620,000	180,000	800,000
Marsha	180,000	800,000	620,000	180,000	800,000
Jan	180,000	800,000	620,000	180,000	800,000
Greg	180,000	800,000	620,000	0	0
	900,000	4,000,000	3,100,000	720,000	3,200,000

Section 704(c)(1)(B)

Section 704(c)(1)(B) applies when property contributed by one partner is distributed to another within seven years of contribution. A transferee is considered to step into the shoes of the transferor for purposes of Section 704(c)(1)(B). Thus, Mike, Carol, Marsha, Jan, and Greg are each considered to be the contributing partner of $160,000 worth of stock (20% of $800,000). Mike, Carol, Marsha, and Jan will each recognize $120,000 of gain on the distribution They will each be receiving a corresponding basis increase in their partnership interests. Greg will not recognize gain under Section 704(c)(1)(B) because he is considered to be receiving property which he previously contributed to the partnership.

The total Section 704(c)(1)(B) gain is $480,000.

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[1] For purposes of these Examples, we will disregard the economic interest owned by the general partner.

Section 704(c)(1)(B)

	FMV	Adjusted Basis	Total
Mike	160,000	40,000	120,000
Carol	160,000	40,000	120,000
Marsha	160,000	40,000	120,000
Jan	160,000	40,000	120,000
Greg	N/A	N/A	N/A
	640,000	160,000	480,000

Section 731(c)

Under the general rule of Section 731, a partner recognizes gain to the extent that a distribution of money exceeds his adjusted basis in his partnership interest. Under Section 731(c) marketable securities are treated as money. Section 731(c)(3)(A)(i) provides an exception for a distribution of marketable securities to the partner who contributed such marketable securities. However, unlike Section 704(c)(1)(B), Section 731(c)(3)(A)(i) has no step in the shoes rule for a transferee of a partnership interest to step into the shoes of the contributing partner.

Greg has received a distribution of $800,000 of marketable securities and his adjusted basis in his partnership interest is $180,000, so he will recognize a potential gain of $620,000. However, Section 731(c)(3)(B) offers some relief. It provides that the amount of money which a distributee partner is deemed to receive under Section 731(c) is reduced by the partner's share of net gain of the partnership's total marketable securities immediately before the distribution over the distributee partner's share of gain immediately after the distribution. The purpose of Section 731(c)(3)(B) is to allow a partner to receive his portion of the appreciated marketable securities tax-free. A partner will only recognize gain in the case of a non pro rata distribution of marketable securities to the partner where the partnership retains other appreciated assets.

In this case, the partnership has a total of $1,500,000 net gain in its marketable securities prior to the distribution and Greg's portion is $300,000 (20% * $1,500,000). Since Greg will not own any partnership interest after the distribution to him, his portion of the gain of the marketable securities after the distribution is $0.

Thus, Greg's Section 731 gain is $320,000.

Section 731(c)

Marketable Securities	800,000
Less: Greg's AB in partnership	180,000
Potential 731(c) Gain	620,000

Section 731(c)(3)(B) Reduction

Greg's share of net gain of securities before distribution	300,000
Less: Greg's share after distribution	0
	300,000

Potential 731(c) Gain	620,000
Less: Section 731(c)(3)(B) Relief	300,000
Total Section 731(c) Gain	**320,000**

Section 737

Section 737 applies when a partner contributes appreciated property to a partnership and receives a distribution of property within seven years of the contribution. However, the marketable securities distributed are considered money for purposes of Section 737 and Section 731(c), so Section 737 is not applicable in this situation.

Recap of Gain

Recap of Gain

Section 704(c)(1)(B) Gain	480,000
Section 731 (c) Gain	320,000
	800,000

Assuming a 15% long-term capital gains rate, the total tax is $120,000. Unfortunately, the other family members will have no cash distribution from the partnership to pay the tax liability associated with the Section 704(c)(1)(B) gain and the partnership may be forced to liquidate more securities, which will generate additional tax liability, in order to be able to distribute cash.

Greg’s Basis in the Marketable Securities

Since Greg has received the marketable securities in liquidation of his partnership interest, his tax basis in the marketable securities will be equal to his basis in his partnership interest of $180,000 under the rules contained in Section 732. However, he will receive a basis increase equal to the amount of gain he recognized under Section 731(c) of $320,000 so his adjusted basis in the securities is $500,000.

Assuming Greg immediately sells the securities, he will recognize gain of $300,000.

Greg's gain on sale of marketable securities

FMV of Securities Sold	800,000
Less:	
Greg's AB in partnership	(180,000)
Increase for Section 731Gain	(320,000)
	300,000

Total Family Gain

The total family gain on the distribution of the marketable securities to Greg is $1,100,000.

Recap of Gain

Section 704(c)(1)(B) Gain	480,000
Section 731(c) Gain	320,000
Greg's Gain on Sale of Securities	300,000
Total Family Gain	**1,100,000**

Section 704(c)(1)(A)

If instead of distributing the marketable securities to Greg, the partnership sold them and distributed the $800,000 of proceeds to Greg in liquidation of his partnership interest, the total gain would be $1,100,000.

Section 704(c)(1)(A)

FMV of Securities Sold	800,000
Less: Adjusted Basis	(200,000)
Total Partnership Gain	600,000
Distribution of Cash to Greg	800,000
Less:	
Greg's Original Adjusted Basis	(180,000)
Increase for Gain on Sale	(120,000)
Greg's Gain on Distribution	500,000
Total Gain	**1,100,000**

Planning Opportunities

If the partnership waits until after January 1, 2010 to make the distribution of marketable securities, the Section 704(c)(1)(B) gain can be eliminated.

Example 2: Siblings who don't want to be partners

On January 1, 2003, Mike and Carol met with their estate planning attorney about forming a limited partnership to hold undeveloped real estate which they hoped their children would develop. Mike and Carol decided to gift all of their partnership interests to their children rather than worry about Section 2036 problems.

Mike and Carol die unexpectedly in a plane crash on July 15, 2005. On August 1, 2005 the three siblings meet and all agree that they have no interest in being partners with each other and agree to liquidate the partnership with Marsha taking the cash and Parcel #1, Jan taking Parcel #2, and Greg taking Parcel #3.

	January 1, 2003			**August 1, 2005**		
	Adjusted Tax Basis	**FMV**	**Pre Contribution Gain**	**Adjusted Tax Basis**	**FMV**	**Post Contribution Appreciation**
Cash	$200,000	$200,000	$0	$200,000	$200,000	$0
Parcel #1	$600,000	$800,000	$200,000	$600,000	$800,000	$0
Parcel #2	$500,000	$700,000	$200,000	$500,000	$1,000,000	$300,000
Parcel #3	$500,000	$900,000	$400,000	$500,000	$1,000,000	$100,000
	$1,800,000	$2,600,000	$800,000	$1,800,000	$3,000,000	$400,000
Mike	$900,000	$1,300,000	$400,000	$0	$0	$0
Carol	$900,000	$1,300,000	$400,000	$0	$0	$0
Marsha	$0	$0	$0	$600,000	$1,000,000	$133,333
Jan	$0	$0	$0	$600,000	$1,000,000	$133,333

Greg	$0	$0	$0	$600,000	$1,000,000	$133,333
	$1,800,000	$2,600,000	$800,000	$1,800,000	$3,000,000	$400,000

Section 704(c)(1)(B)

Under the "step in the shoes" rule, each of the siblings is treated as the contributor of an undivided one-third interest in each of the three parcels of real estate. However, since the siblings each received a separate parcel, each will recognize some amount of Section 704(c)(1)(B) gain.[2]

Marsha and Jan each recognize $200,000 of Section 704(c)(1)(B) gain, and Greg recognizes $133,333 of Section 704(c)(1)(B) gain.

Section 704(c)(1)(B)

	Marsha	**Jan**	**Greg**	**Total**
Parcel #1	$0	$66,667	$66,667	$133,333
Parcel #2	$66,667	$0	$66,667	$133,333
Parcel #3	$133,333	$133,333	$0	$266,667
	$200,000	$200,000	$133,333	$533,333

Section 731

The distribution of the Parcels will not trigger any gain under Section 731 because they are neither money nor marketable securities treated as money under Section 731(c).

Marsha has an adjusted basis in her partnership interest in excess of the cash distribution of $200,000 received by her, so she will not recognize any gain upon the distribution.

Section 737

Gain must be recognized under Section 737 upon a distribution to the extent of the lesser of the excess distribution or net precontribution gain. However, there is an exception for a distribution of previously contributed property.

The children step into the shoes of their parents with respect to the net precontribution gain, but Section 737 is silent as to whether they step into the shoes for purposes of the previously contributed property exception. Assuming that the children do not step into the shoes of their parents for purposes of the previously contributed property exception, Section 737 gain will be recognized as follows:

Section 737 - No Step in the Shoes for Previously Contributed Property

Excess Distribution

	Marsha	**Jan**	**Greg**
FMV of Property	$800,000	$1,000,000	$1,000,000
Less:			
Initial Adjusted Basis	$600,000	$600,000	$600,000
704(c)(1)(B) Gain	$200,000	$200,000	$133,333
Cash Distribution	($200,000)	$0	$0

[2] For purposes of this Example we will assume that none of the three parcels are like-kind property.

Excess Distribution	$200,000	$200,000	$266,667

Net Precontribution Gain

	Marsha	**Jan**	**Greg**	**Total**
Precontribution Gain	$266,667	$266,667	$266,667	$800,000
Less: 704(c)(1)(B) Gain	$200,000	$200,000	$133,333	$533,333
Net precontribution gain	$66,667	$66,667	$133,333	$266,667
Section 737 Gain	**$66,667**	**$66,667**	**$133,333**	**$266,667**

If the children do step into the shoes of their parents for purposes of the previously contributed property exception, then no Section 737 gain will be recognized because they will each be able to exclude one-third of the value of the property under the excess distribution test. The excess distribution calculation produces a negative amount, so no Section 737 gain is triggered.

Section 737 - Step in the Shoes for Previously Contributed Property

Excess Distribution

	Marsha	**Jan**	**Greg**
FMV of Property	$533,333	$666,667	$666,667
Less:			
Initial Adjusted Basis	$600,000	$600,000	$600,000
704(c)(1)(B) Gain	$200,000	$200,000	$133,333
Cash Distribution	($200,000)	$0	$0
	($66,667)	($133,333)	($66,667)

Planning Opportunities

The Section 704(c)(1)(B) gain could have been avoided if the siblings each received an undivided one-third interest in each Parcel or if they waited to make the distribution until after January 1, 2010, which is seven years after the contribution of the Parcels. Additionally, if the like-kind property exception was available, the Section 704(c)(1)(B) gain could have been avoided.

The Section 737 gain could have been avoided if the siblings waited until after January 1, 2010 to make the distribution. Alternatively, if the siblings took the position (and the inherent risk) that the step in the shoes rules applied to the previously contributed property exception under Section 737, then the Section 737 gain could be avoided without waiting the seven years.

Example 3: Liquidating Estate Assets to Pay Estate Tax Liability

On January 1, 2003, Mike transferred $1,200,000 of cash into a limited partnership in exchange for 40% of the partnership interests and his three children each transferred $600,000 of cash to the partnership in exchange for 20% partnership interests. The partnership was formed with the intention of investing in real estate. At Mike's death, Mike held a 40% interest and each of his three children owned a 20% interest. The partnership purchased one parcel of real estate for $1,000,000 which appreciated to $3,000,000 at Mike's death. The partnership held the remaining $2,000,000 in cash while investigating future acquisition opportunities.

The estate tax liability was projected to be $2,000,000, and Mike's estate consisted of mostly illiquid assets. The children discussed selling the real estate and liquidating the partnership which would allow the estate to receive enough cash to satisfy the estate tax liability. However, Marsha, the oldest daughter, recently had a malpractice judgment rendered against her. Her attorney advised her that if the partnership was liquidated and she received cash, her creditors would seize the cash, but a creditor would most likely be limited to obtaining a charging order against her partnership interest. Therefore, the children decided to distribute $2,000,000 of cash out to the estate in liquidation of its partnership interest.

	January 1, 2003			August 1, 2005	
	Adjusted Tax Basis	**FMV**	**Pre-Contribution Gain**	**Adjusted Tax Basis**	**FMV**
Cash	3,000,000	3,000,000	0	2,000,000	2,000,000
Real Estate	0	0	0	1,000,000	3,000,000
	3,000,000	3,000,000	0	3,000,000	5,000,000
Mike	1,200,000	1,200,000	0		
Estate				1,200,000	2,000,000
Marsha	600,000	600,000	0	600,000	1,000,000
Jan	600,000	600,000	0	600,000	1,000,000
Greg	600,000	600,000	0	600,000	1,000,000
	3,000,000	3,000,000	0	3,000,000	5,000,000

Section 754

The partnership should make a Section 754 election, which will have the effect of increasing the estate's basis in its share of the partnership's assets up to the estate's adjusted basis in its partnership interest. The estate will receive a step up in basis in its partnership interest to its fair market value at the date of Mike's death. Because of the discounts taken by the appraiser in valuing the partnership interest, the partnership interest was valued at $1,400,000. Thus, the estate's inside basis in the partnership assets becomes $1,400,000. If no Section 754 election were made, the estate would have had a $1,200,000 carryover basis. If the appraised value had been less than $1,200,000, then it would not have been advisable to make a Section 754 election because the carryover basis would be higher.

Section 754

Discounted Value of Mike's Partnership Interest	1,400,000
Inside Basis of Real Estate	1,200,000
Section 754 Adjustment	**200,000**

Section 704(c)(1)(B)

Because no appreciated assets were contributed to the Partnership, there is no Section 704(c)(1)(B) gain.

Section 731

Under Section 731, if a partner receives a distribution of money in excess of his basis in his partnership interest, the partner will be required to recognize gain on the distribution. Therefore, the estate will recognize $600,000 of gain on the distribution because it will have an adjusted basis in its partnership interest of $1,400,000 and it will receive a distribution of $2,000,000.

Section 731(c)

Distribution	2,000,000
Less:	
AB of Partnership Interest	1,400,000
Section 731 Gain	**600,000**

Section 737

No Section 737 gain must be recognized because there is no net precontribution gain, and the test under Section 737 applies to the lesser of net precontribution gain or excess distribution.

Planning Suggestions

The partnership could loan funds to the estate under a *Graegin*-type loan in which the estate would be entitled to deduct the present value of the interest payments to be made to the partnership over the life of the loan. Although the loan and related interest deduction will not minimize the income tax liability upon the sale the ultimate sale of the real estate and any related cash distribution, it will reduce the estate's need for liquidity so that the estate may not need to have its partnership interest completely liquidated.