SO THEY WANT TO DISSOLVE THE FAMILY LIMITED PARTNERSHIP - IS IT THAT SIMPLE?

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SO THEY WANT TO DISSOLVE THE FAMILY LIMITED PARTNERSHIP - IS IT THAT SIMPLE?

April 9, 2010

I. INTRODUCTION.

The Family Limited Partnership ("FLP") has been a popular estate planning tool for more than 20 years and it is a testament to the many benefits derived from this tool that it has remained a steady component of the estate planning toolbox for that period of time. Still, clients' careers, families, financial condition, and attitudes change over time and as those change, so do their estate planning objectives. Asset protection objectives that used to be front and center may move to the back burner as the client retires from a profession subject to malpractice exposure or from a business that puts family assets at risk due to personal liability and debt exposure. The use of limited partnership interests as a gifting tool to children to retain control of the family assets in the hands of the parents may no longer be a priority as the children have grown into adults and shown the maturity and responsibility to handle the management of their inherited assets. Estates that were once subject to a significant estate tax exposure at the time that the FLP was formed in the 1980s or 1990s may no longer be facing that exposure as the value of the estate has leveled or dropped, while the estate tax exemption rose to as high as $3,500,000 per person as of 2009.

As the client's needs and objectives evolve over time, the benefits of the FLP can begin to diminish and the administrative costs of maintaining that FLP become more prominent. Recordkeeping, tax complexities and reporting, maintenance of bank accounts and other operating procedures are subject to more scrutiny by the client in light of the diminishing returns and, in addition, these operating procedures become more of a burden to the client as he or she begins to work towards shifting into a retirement mode.

With these points in mind, it is the natural progression of the life of an FLP that at some point the client may come to you with either a question about the viability of dissolving the FLP or, just as likely, a direction that he or she is ready to dissolve the FLP. The reality is that an FLP is a separate legal entity that has been formed, operated, and must be dissolved under the laws of the State and the applicable provisions of the Partnership Agreement. In carrying out that dissolution, there are important decisions that must be made with respect to the closing down of the partnership operations, settling creditor claims, dealing with existing and ongoing contracts, and distributing the remaining assets to the partners. The person or persons responsible for making those decisions and carrying out those action steps must consider the rights of all partners, as well as third parties that are affected (such as banks, creditors, etc.). In addition, there are significant tax and non-tax consequences that can result from the decisions and action steps taken with regard to dissolving an FLP, and those consequences must be identified and factored into the decision-making process.

Thus, the first step to take in addressing a client's desire to consider dissolving an FLP is to put the brakes on and say "wait a minute." Specifically, the first step should be to identify all of the issues and potential consequences that can flow from dissolving the FLP and to decide whether or not the dissolution of that entity is actually in the client's best interest. Second, if the decision is made to dissolve the FLP after considering all the issues and consequences, then it is critical that the action steps taken to dissolve, liquidate, and terminate that entity be done in a manner so as to avoid the tax traps and adverse non-tax consequences that await the uninformed.

The remaining parts of this outline address factors that should be considered in reaching a decision as to whether or not to dissolve an FLP and, if that decision is made in the affirmative, in taking the steps to safely dissolve, liquidate, and terminate that FLP.

II. DECISIONS, DECISIONS, DECISIONS.

The procedures to be followed to dissolve, liquidate, and terminate a Texas limited partnership are outlined in the Partnership Agreement and, if not addressed in the Agreement or a statutory provision that cannot be overridden, in the Texas Business Organizations Code. One of the key elements of these procedures involves the necessary role that the partners play in voting and making decisions that are necessary in order to dissolve the partnership. For example, most Partnership Agreements allow a partnership to be dissolved voluntarily by the unanimous vote of all partners. Thus, the parents that formed the partnership and transferred ownership interests to various family members and/or other third party owners (such as charities) cannot unilaterally decide to dissolve, liquidate, and terminate the partnership, but the agreement of all of the partners is required to begin that process.

Another critical factor that will be determined under the applicable Agreement and State law is the identification of the partner, partners, or third party liquidator who will be appointed to wind up the affairs of the partnership, liquidate and sell its properties, and distribute remaining assets in kind to the creditors and/or partners of the partnership. Again, one of the first steps that should be taken in assessing the viability of dissolving an FLP is to identify the procedure that must be followed for naming the person or persons who will be in charge of making the critical decisions as to how that dissolution, liquidation, and termination will be carried out. Specifically, perhaps the most important decision that will be made in this process is to determine whether specific assets of the partnership will be sold by the partnership or distributed in kind to the partners and, if that distribution is to be made in kind, how the assets will be divided among the partners and which partners will get specific assets or percentage ownership interests in those assets.

There are significant tax and non-tax consequences that accompany the decision as to distribute assets in kind or sell those assets and distribute cash to the partners. Among the factors to consider in this process include:

1. the income tax consequences from the sale of assets by the partnership, including potential changes in the income tax laws;

2. changes in the value of partnership assets and the best time for the sale of those assets;

3. the existence of "family assets" that might be off limits for sale consideration, including a family farm, family business, and real estate used in a family business;

4. income tax traps in the distribution of cash and assets in kind from a partnership (discussed below in Article IV);

5. the existence of "good" assets (such as assets with high appreciation potential, income-producing features, or those with sentimental value) and "bad" assets (such as assets that do not have appreciation potential and/or income-producing features, those that are hard to sell, and the like) and which of the partners will get the good assets and which will get the bad assets; and

6. whether to distribute whole assets to individual partners or to distribute an undivided ownership interest in assets to multiple partners.

Needless to say, the decision to dissolve an FLP (and the steps that will be taken in carrying out that dissolution) should be greatly influenced by the tax consequences that will result from the sale or distribution of assets in kind, but the non-tax consequences can be just as important to the partners, and, in some cases, the potential for family disharmony from the process of dissolving, liquidating, and distributing assets to the partners can be as important as any other factor in deciding whether or not to dissolve an FLP.

III. BREAKING UP CAN BE HARD TO DO.

FLP's are not quite as unique as snowflakes, but it is a fact that each FLP has its own features involving the types of assets that it owns, the ownership structure, and other factors that are relevant in assessing the consequences that will follow from the dissolution, liquidation, and termination of that FLP. Likewise, there are some universal factors that will impact each FLP in its dissolution decision-making process. One of the reasons that the FLP has been such a popular estate planning tool, and a key factor in supporting some of the benefits obtained through the use of an FLP such as asset protection and estate and gift tax discounts, is that there are a myriad of benefits obtained from placing family assets into a Texas limited partnership. Some of these benefits may not have been the driving force in setting up the partnership, but they can be the exact factors that make it hard to pull the trigger and dissolve the partnership.

A. Liability Exposure - Inside Liability.

A Texas limited partnership protects its limited partners from personal liability for the debts, expenses, and obligations of the partnership and the partnership assets, while the general partner(s) is/are personally responsible for those partnership liabilities. Typically, an entity (e.g. limited liability company) is formed to own the general partnership interest and thus shelter its owners from the general partner liabilities. Many FLP's are formed to own and operate liability-generating assets, such as residential rental real estate. In these cases, the partnership is providing a valuable asset protection tool for the individual owners and that is an important factor that has to be considered in the decision as to whether or not to dissolve that FLP.

A decision to dissolve an FLP that owns a liability-producing asset and to distribute that asset in kind to the partners can remove the liability protection provided by the entity and leave the partners individually responsible for the liabilities of the distributed asset. That liability exposure can be a significant problem to some partners. For example, an individual partner that is retired and is deriving his or her financial security from a portfolio of investment assets held in his or her name would have that financial security put at risk by coming into ownership of a liability-producing asset. Likewise, in many cases the partners of a partnership are trusts that have been established for the children of the founding partners and those trusts can have over time, through the receipt of other gifted assets or through the receipt of distributions from the partnership, accumulated assets of substantial value; but, it is very unlikely that those assets consist of liability-producing assets that would put the other trust assets at risk. The receipt of a liability-producing asset from the dissolution of a partnership would adversely impact the risk exposure of those trust assets.

An initial response to this potential problem is to have the owners place the liability-producing asset in an entity that provides liability protection for the owners. However, in most cases, that entity would bring the same administrative costs and burdens that were seeking to be avoided in the dissolution of the FLP. Another common, more practical, answer might be available. In many cases wherein a client has placed a liability-producing asset in an FLP, he or she has also formed one or more other FLP's to own "safe" assets that have no liability-generating potential (i.e., stocks, bonds, limited partnership interests, etc.). The practical answer to the client's desire to dissolve the FLP would be to dissolve the safe asset FLP, but retain the FLP that owns the liability-producing asset and endure the administrative costs of that FLP in return for the asset protection benefits that it provides.

B. <u>Liability Exposure - Outside Liability</u>.

Under Section 153.256 of the Texas Business Organizations Code, a creditor of a partner does not have the right to claim possession of, or otherwise exercise legal or equitable remedies with respect to, the property owned by an FLP. Further, the rights of that creditor of the limited partner are limited to obtaining a charging order against the partner's partnership interest that will entitle the judgment creditor to receive any distributions from the partnership that would otherwise be made to the partner. That is the extent of the judgment creditor's rights with respect to the debtor partner's partnership interest and assets of the partnership, including the fact that the creditor may not foreclose upon the partnership interest and obtain outright ownership of that interest. The impact of Section 153.256 is to cause assets owned by the partnership that would otherwise be subject to reach by an individual partner's creditors, if held in that partner's outright ownership, such as marketable securities, cash, and real estate, to be protected from the reach of that creditor. Further, the charging order only entitles the creditor to distributions that would otherwise be made from the partnership to the debtor partner, and the creditor has no ability to vote the partnership interest or otherwise impact its partnership decisions, including those decisions made with respect to the timing and amount of distributions to the partners.

As with respect to the "inside" liability protection offered by a Texas limited partnership, the protection offered by the limited partnership from partnership assets being seized by a partner's personal creditors would be lost upon the dissolution of the partnership.

To the extent that the partner has personal liability concerns, those concerns must be addressed in making the decision as to whether or not to dissolve the partnership and distribute partnership assets outright to that partner. After such consideration, it is possible that remedial steps can be taken following the dissolution of the partnership to achieve the desired asset protection without the burdens and costs of the FLP. Specifically –

1. Cash proceeds (and cash equivalents such as marketable securities that are converted to cash) can be placed in asset protected vehicles such as life insurance policies and annuities.

2. Assets received in the distribution from the partnership that are exposed to the partner's individual creditors can be conveyed away from that risk exposure through a gifting program. However, prior to using this gifting program as a tool to protect those assets from creditors' reach, it is important to note that a gift of partnership interests, as opposed to a gift of the assets owned by the partnership and distributed to the partner, will be eligible for gift tax valuation discounts that will allow the individual to leverage his or her annual gift tax exclusion, gift tax exemption, and GST exemption. Thus, the overall gifting strategy should be reviewed and set prior to the dissolution of the partnership.

C. Consolidation of Assets.

One of the benefits offered by a Texas limited partnership is the ability to consolidate fractional ownership interests ind assets into a unified ownership structure that allows for a more efficient/cost-effective management of those assets. In some cases, the consolidation of fractional ownership interests occurs at the formation of the partnership as the multiple partners transfer in those ownership interests to the partnership which acts a single owner for property management purposes (i.e., a consolidation of family members' undivided ownership interests in a family ranch into a single owner partnership). In other cases, what starts out as a wholly-owned asset ends up being owned by the partnership on behalf of multiple partners as gifts of limited partnership interests are made to children, trusts for children and/or other third party owner such as charities.

Either way, upon the dissolution of an FLP and the distribution of the asset(s) owned by the FLP in kind, it may be impossible to distribute such asset outright to the partners in any way other than undivided ownership interests for each partner. For example, assume an FLP with a Texas limited liability company as the 1% general partner and parents (each owning separate property interests), children and children's trusts as the limited partners. Further, assume that the only asset of the FLP (other than an insubstantial amount of cash) is a 500-acre family farm. In this case, upon dissolution of the partnership, unless the family farm is sold, the partners would each receive an undivided ownership interest in that family farm.

Alternatively, the assets of the FLP may consist of stocks, bonds, and other like investments. Under the same ownership structure, those investments would be divided between the family members/partners on a pro-rata basis. In any case, the fact that the assets that are held under consolidated management in the partnership structure will be distributed out to the partners to be held individually by those partners, either in a fractional or wholly-owned ownership mode or wholly owned ownership mode, and this is a factor that must be considered in making the dissolution decision. Factors to include in that decision-making process are:

1. Leasing, sale, and other decisions with respect to real estate owned by a partnership is made by the general partner, without the potential interference of limited partners. Once the real estate is distributed outright to the partners who hold an undivided ownership interests, the ease of management provided by the single owner partnership can be lost.

2. A concentration of investment assets in an FLP can provide benefits to the individual partners that they might not be able to obtain in their individual position. For example, consolidated assets can allow the partnership to meet minimum investment standards set by a desired investment manager, and can also allow for a greater diversification of assets in putting together the investment mix.

3. In some cases, the assets have been consolidated in the partnership for a reason. For example, assume Mrs. Smith has $2,500,000 of marketable securities and other investments that provide her with financial security for her lifetime and are managed by her son. After her death, Mrs. Smith desires that those investment assets be divided into three equal shares for her two sons and daughter, but also wants the assets to be held under a single management structure with her son as the investment manager. For this reason, the assets were placed in an FLP during Mrs. Smith's lifetime. A dissolution of that partnership, during her lifetime or after, would not only work against Mrs. Smith's wishes but also might not be in the best interests of any one of her children.

4. Partnerships provide an efficient mode for the ownership and administration of oil and gas interests. The partnership structure allows for a single owner with respect to each property, a single check paid with respect to that property, and a single recipient /payer with respect to operating expenses on operating wells. This simplicity and efficiency is lost when the oil and gas interests are distributed outright to the individual partners upon dissolution of the partnership.

D. **Control**.

One of the unique features of the limited partnership form of business entity is that it bifurcates the ownership of the partnership into limited partnership interests and general partnership interests. This allows a parent to transfer a significant amount of family wealth to children, grandchildren, and trusts for those family members through gifts of limited partnership interests without parting with the ability to control and manage that wealth. Specifically, parents can retain a small general ownership interest and control the assets of the partnership even though they have transferred the majority of the limited partnership interest to their designated transferees. In some cases by design, and other cases just by the passage of time and the implementation of gifting plans, the ownership of the FLP is structured with the parents holding very little equity in the entity.

Still, the retention of that small general partnership interest (either outright or through an entity) allows the parents to control:

1. The management and administration of partnership assets, including the decisions with respect to the types of assets to be owned by the partnership, investment mixes, management and operation of real estate, etc.

2. Whether and when to sell specific partnership assets and whether to reinvest or distribute the cash proceeds from such sales.

3. The timing and amount of cash distributions to the partners.

Upon deciding to dissolve a partnership and distribute the assets of that partnership in kind, the parents will be effectively giving up control of those partnership assets in most cases. This decision can have significant consequences, as the assets are passed to the children, grandchildren, and trusts for those family members along with the ability to control all aspects of the ownership of those assets. Of course, the extent to which the control of partnership assets passes to the children and/or grandchildren depends upon whether or not those heirs' interests are held outright or in trust and, if the partnership interest is held in trust, who is the trustee (another family member, a bank or trust company, or the child/grandchildren as Trustee of his or her own trust).

E. <u>Transfer Tax Discounts</u>.

The transfer of assets by gift to children, grandchildren and trusts must be made in consideration of the federal transfer tax consequences of same. Basically, the value of the assets for transfer tax purposes is the fair market value of the assets on the date of the transfer. Cash, stock, bonds, real estate, etc. that are transferred in whole to the recipient are valued at the full fair market value of the asset on the date of the transfer. However, if such assets are held in a limited partnership and the recipient is given a limited partnership interest in that partnership, not ownership of the assets directly, then the value of the limited partnership interest for transfer tax purposes is, generally, subject to a discount to reflect lack of marketability and lack of control. Thus, any decision to dissolve an FLP and return assets owned by that FLP to the estates of the founding parent(s) must be made after consideration of the loss of that discount upon the later transfer of those assets by the parent or parents during their lifetime or at death.

Of course, the unsettled nature of the federal transfer tax system makes that analysis more complicated. Notwithstanding issues such as whether or not there will be estate and generation-skipping transfer taxes for 2010, future exemption levels for those taxes, the possibility of reunification of the gift and estate taxes, and future tax rates, the transfer tax consideration should still factor into the partnership dissolution decision.

In some cases, particularly for clients who have substantial wealth and are getting older in years, there are factors that come into play that cause them to want to make lifetime transfers to their heirs. These factors can include: a desire to get assets in their children's hands now, instead of the children having to wait until the parent dies at a time when the children themselves may be much older; a recognition of significant wealth and the desire to share that wealth with the children and grandchildren while still living; federal transfer tax savings to be achieved by taking full advantage of what is now a $1,000,000 lifetime gift tax exemption, annual gift tax exclusions, and, especially for larger estates, the federal transfer tax savings offered through the use lifetime taxable gifts.

When, based upon the client's situation, there are factors to indicate that the client will want to make lifetime transfers of assets received from the FLP, the "cost" of the loss of the discount on those transfers for valuation purposes is a greater factor in the dissolution decision-making process.

F. <u>Financial Security</u>.

As with all estate planning decisions, it is important to not "put the cart before the horse" and allow the implementation of estate planning tools to put the parents' long-term financial security at risk. That is certainly the case in the decision to dissolve an FLP. A critical component of this analysis is to understand that the relative position of the family members/partners with respect to the partnership assets after the dissolution can be materially different than it is before the dissolution.

As an example, consider an FLP established by the founding parents that has been in place for many years. Over the years the parents have transferred 89% of the limited partnership interests to trusts for their children and have retained a 10% limited partnership interest and the 1% general partnership interest. Over those years, the parents have retired and they have seen some diminution in the value of their overall estate. At the present time, the parents' financial security is tied to cash that they are receiving from the partnership in the form of periodic partnership distributions (in which they receive 10% of the overall distribution) and a salary that they derive from managing the partnership assets as general partner. In this case, care should be taken in making a partnership dissolution decision and some of the factors that should be considered include:

1. Depending upon the asset mix of the partnership, the partnership's rate of return on the investments might exceed the rate of return that the parents will be able to obtain on their 10% ownership interest in partnership assets.

2. Once the partnership is dissolved, the partners will no longer receive the salary that they were paid for managing partnership assets. It is conceivable that this salary could be replaced through some other form of compensation with respect to the former partnership assets, but the loss of that salary is a definite possibility.

G. <u>Restrictions on Transfer</u>.

Though it is common for parents to transfer limited partnership interests to trusts for their children and grandchildren, it is not uncommon for those limited partnership interests to be owned outright by children of the founding partners. In addition to the control factor mentioned above that allows the parents to transfer substantial family wealth to the children through gifts of limited partnership interests but retain control of that wealth, there are other characteristics of a limited partnership interest that favor it as an ownership form for the children as opposed to outright ownership of the underlying partnership assets.

1. Provisions in the Partnership Agreement can prohibit the child from transferring his or her limited partnership interests by gift, sale, hypothecation, or other means, or restrict those transfers by limiting them to a defined class of permitted transferees.

2. As opposed to outright ownership in stocks, bonds, and other such assets, a limited partnership interest is less likely to be commingled and thus lose its character as separate property for marital property purposes.

3. As mentioned above, gifts of limited partnership interests to children cause the underlying assets held in the partnership to be protected from seizure by that child's creditors.

In sum, the dissolution of a partnership and distribution of partnership assets outright to children/partners can tear down important benefits provided by the partnership in the form of protecting and retaining family assets for the benefit of family members.

H. <u>Incapacity Protection / Probate Avoidance</u>.

To sum up a general theme that is present in the partnership dissolution analysis, there are subtle details and consequences that come from the dissolution of a partnership that can be overlooked but still result in significant, adverse consequences to the parties. One of those details that can be overlooked is the fact that the partnership provides a legal, respected structure for the management of partnership assets. The general partner has the duty and responsibility to manage the assets of the partnership and is recognized in the "real world" as having full authority to so manage the assets. If that general partner (be it an individual general partner, or a president of an LLC general partner) becomes incapacitated and is no longer able to manage the partnership assets, then a system is in place for a smooth transition to the successor manager without the need for reliance upon powers of attorney, guardianships, etc. Once a partnership is dissolved, the assets that pass outright to the founding parent will no longer be subject to that management system in the event that the founding parent becomes incapacitated and unable to manage the assets that are now owned in his or her name. The loss of this incapacity protection can be significant and must be considered.

Likewise, assets held in a partnership at the time of the death of a partner are not listed on the partner's probate inventory filed in the County probate records. The partnership interests would be listed, but not the underlying assets. This element of privacy can be very beneficial, such as in the case of an elderly surviving spouse who can be subject to corrupt individuals who might prey on that spouse upon identifying the type and value of assets the spouse owns through the review of a probate inventory filed for the estate of a predeceased spouse.

Fortunately, the loss of incapacity protection and the probate avoidance benefits can be overcome following the dissolution of a partnership by transferring the assets received by the founding parent/partner to a living trust for his or her benefit.

IV. LIQUIDATION OF A PARTNERSHIP - THE TAX TRAPS.

There is a perception that a limited partnership may be liquidated without income tax recognition. However, the truth is that many distributions of property from a partnership do, in fact, trigger gain, and thus, require further examination. Specifically, three major income tax traps exist under the Code, which can prevent a tax-free liquidation. Such tax traps will be explored in the following paragraphs.

When a partnership wishes to unwind or dissolve, it has two basic options for effecting such a change: (a) sell the entity's assets and distribute the cash proceeds after paying all partnership debts; or (b) distribute the assets in kind to the partners.

A. Sale of Partnership Assets. If the partnership wishes to sell the assets and distribute cash to the partners, Section 704(c)(1)(A) requires any gain from the sale of appreciated property contributed to the partnership be allocated among the partners in a manner that takes into account the property's built-in gain at contribution.[1] Therefore, if any partner contributes property to a partnership ("contributed property") with a fair market value in excess of its adjusted basis ("built-in gain"), and the partnership sells the contributed property, the built-in gain must be allocated to the contributing partner and any excess gain may be allocated as determined by the partnership agreement.[2] Generally, the partnership agreement will allocate excess gain to the partners in proportion to their partnership interests. An individual or entity that succeeds to all or a portion of a contributing partner's partnership interest (the "contributing partner's assignee") will inherit that partner's share of the built-in gain attributable to the interest received.[3] Following the recognition and pass-through of gains and losses from the sale of the assets and required adjustments to a partner's basis in the partnership interest (the "outside basis"), a distribution of cash is taxable only to the extent that the distributed cash exceeds the partner's outside basis.[4] A partner's outside basis must be increased by the partner's share of partnership income and gain items and reduced by the partner's share of partnership losses and expenditures.

B. Distributions of Partnership Assets In-Kind. The remaining paragraphs in this section will focus on distributing assets in-kind to the partners since the majority of tax traps surrounding partnership dissolution result from this particular dissolution option. Once a partnership has made the decision to liquidate by distributing its assets in-kind to the partners, such distributions can either by done (a) proportionately so that each partner receives a share of every asset owned by the partnership according to the partner's interest or (b) selectively (a.k.a. "cherry picking") so that entire assets are distributed to one partner to the extent possible.

A distribution from a partnership to a partner is not taxable to the partner <u>except</u> to the extent that: (a) Section 704(c)(1)(B) applies; (b) the amount of "money" distributed exceeds the partner's basis in the partnership (*see* Section 731(c)); or (c) Section 737 applies. In exploring these tax traps,

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[1] Section 704(c)(1)(A).

[2] *Id*.

[3] Treas. Reg. 1.704-3(a)(7).

[4] Section 731(a)(1).

it is important to note the ordering rules for their application. If a distribution results in the application of Section 731(c) and one or both of Sections 704(c)(1)(B) and 737, the Treasury Regulations provide that the effect of the distribution is determined by applying Section 704(c)(1)(B) first, Section 731(c) second and finally Section 737.

1. **Section 704(c)(1)(B)**. Under Section 704(c)(1)(B), if contributed property is distributed to another partner ***within seven (7) years*** of being contributed, the contributing partner must recognize the built-in gain (or loss) on the contributed property at the time of the distribution. If a contributing partner transfers his or her partnership interest, the transferee partner steps into the contributing partner's shoes for purposes of Section 704(c)(1)(B).[5] Thus, any transferee partner would be required to recognize the built-in gain (or loss) on contributed property that the contributing partner would have had to recognize at the time of distribution to another partner. There is a "return-to-sender" exception so that recognition of built-in gain (or loss) is avoided if the distribution of the contributed property is back to the contributing partner.[6] This "return to sender" exception also applies to the contributing partner's assignee so that such partner is treated as the contributing partner to the extent of the built-in gain (or loss) allocable to the transferee partner's interest.[7]

There are two easy solutions to avoid 704(c)(1)(B) gain. The partnership can either (a) distribute the built-in gain property back to the contributing partner (or such partner's assignee), or (b) wait seven (7) years after the contribution before making distributions of property with built-in gain. Of course, such solutions are not always an available option especially when a partnership must liquidate immediately. There are few other options available for avoiding the application of Section 704(c)(1)(B) for property with built-in gain.

2. **Section 731(c)**. If the partnership distributes money (which includes marketable securities as explained below), Section 731(a)(1) generally provides that partners do not recognize gain upon such a distribution except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately prior to the distribution. This rule is applicable to both current distributions and distributions in liquidation of the partner's entire partnership interest.[8] On the other hand, loss will only be recognized to a partner under Section 731(a) upon liquidation of his entire partnership interest and only if the property distributed to him consists solely of money, unrealized receivables (as defined in Section 751(c)) and inventory items (as defined in Section 751(d)).[9]

Under Section 731(c), the term "money" includes marketable securities for purposes of Section 731(a)(1) and such securities are valued at fair market value as of the date of distribution. The term "marketable securities" is defined as financial instruments and foreign currencies which are, as of the date of the distribution, actively traded (within the meaning of Section 1092(d)). Thus,

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[5] Treas. Reg. 1.704-3(a)(7).

[6] Section 704(c)(1)(B).

[7] Treas. Reg. 1.704-4(d)(2).

[8] Treas. Reg. 1.731-1(a)(1).

[9] Treas. Reg. 1.731-1(a)(2).

if a partnership distributes marketable securities, Section 731(c) works to require the distributee partner to recognize gain on such a distribution if the fair market value of the securities on the date of distribution exceeds the basis of the distributee partner's interest in the partnership.

In the event marketable securities are distributed and Section 731(c) applies, the amount of the deemed cash distribution is reduced by the recipient partner's share of gain on the distributed securities as determined by the formula set forth below:

Fair Market Value of the Distributed Marketable Securities

LESS

Distributee's Share of Net Gain on Sale of All of the Partnership's Marketable Securities

PLUS

Distributee's Share of Net Gain on Sale of Retained Partnership's Marketable Securities

EQUALS

Amount of Deemed Cash Distribution.[10]

Thus, once you know the "amount of deemed cash distribution", you can calculate the Section 731 gain (if any) to be attributable to such partner upon the distribution of marketable securities.

The provisions of Section 731(c) provide four exceptions to its application to a distribution of marketable securities. Section 731(c) will not apply to distributions of a marketable security if: (a) the security was distributed to the contributing partner (another "return to sender" exception); (b) subject to certain limitations, the securities were acquired by the partnership in a nonrecognition transaction; (c) the securities were not marketable when first acquired by the partnership (e.g. investment in a company prior to it becoming publicly traded), did not become marketable for at least six (6) months, and were distributed within five (5) years of the date upon which they became marketable; or (d) the partnership is an "investment partnership" and the recipient of the distribution is an "eligible partner".[11] An "investment partnership" is a partnership that has never been engaged in a trade or business and ninety percent (90%) or more of its assets have always consisted of portfolio assets. An "eligible partner" is any partner that contributed nothing but such portfolio assets to the partnership.[12]

Under Section 731(c)'s "return to sender" exception, marketable securities will not be treated as cash so long as they are distributed to the contributing partner, which is consistent with the

[10]Section 731(c)(3)(B).

[11]Section 731(c)(3)(A) and Treas. Reg. 1.731-2(d).

[12]Section 731(c)(3)(C). It is important to note that while the formation of a partnership is generally not a taxable event, Section 721(b) requires recognition of gain where more than eighty percent (80%) of the value of the partnership assets is made up of portfolio assets held for investment.

"return to sender" exception available under Section 704(c)(1)(B). Provided, however, that unlike the exception under Section 704(c)(1)(B), no Treasury Regulation has been issued extending this exception to a distribution of marketable securities to a contributing partner's assignee. Accordingly, those who receive a partnership interest by gift may be required to recognize gain upon distribution of marketable securities even if those securities were contributed by the transferee partner's respective donor.[13]

3. **<u>Section 737</u>**. Congress intended Section 737 to complement Section 704(c)(1)(B) so that together the two provisions deter the use of a partnership to effect tax-free exchanges of built-in gain property.[14] Section 737(a) applies when a partner contributes appreciated property to the partnership and ***within seven years*** of such contribution, receives a distribution of property (other than money). Under Section 737(a), the contributing partner must recognize either the Section 704(c) built-in gain, or, if less, the excess of the distributed property's value over the partner's outside basis immediately prior to the distribution minus any cash received in the same distribution. Section 737 does not allow for the recognition of built-in loss, so that upon distribution of property with built-in loss, such loss will be preserved in the basis of the distributed property.[15]

The following expresses the amount of gain to be recognized by the contributing partner under Section 737(a) in formula form:

The contributing partner must recognize the **<u>lesser of</u>** these two amounts:

1. *Fair Market Value of Property (Other Than Money)*[16] *Distributed to Contributing Partner*

LESS

Contributing Partner's Outside Basis LESS Cash in Same Distribution

EQUALS

Excess Distribution (737(a)(1)); OR

2. *Amount of Section 704(c)(1)(B) Gain Allocable to Contributing Partner if All Contributing Partner's Section 704(c) Assets Distributed to Other Partners*

EQUALS

Net Precontribution Gain (737(a)(2)).

[13] Donaldson, *supra* 4.

[14] *Id.*

[15] Donaldson, *supra* 4.

[16] It is important to note that under Section 731(c), the term "money" also includes marketable securities for purposes of Section 737.

In summary, upon a partnership distribution of property (other than money) to a contributing partner (within seven (7) years of such partner's contribution), such partner will be required to recognize the lesser of "excess distribution" or "net precontribution gain."

A transferee partner is treated as the contributing partner for purposes of Section 737's general gain recognition rule, so that the transferee partner would be required to recognize the same built-in gain (or a proportionate amount if the transferred interest is less than all of the contributing partner's interest) as the contributing partner would have had to recognize.[17] As is the case under Section 704(c)(1)(B) and Section 731(c), Treasury Regulations provide that if the contributing partner receives the property he or she originally contributed to the partnership, Section 737 does not apply (another "return to sender" exception).[18] Provided, however, that similar to Section 731(c), there is no Treasury Regulation extending this "return to sender" exception to the contributing partner's assignee. Accordingly, those who receive a partnership interest by gift may be required to recognize gain under Section 737 even if the property distributed was contributed by the transferee partner's respective donor.[19]

As is the case with Section 704(c)(1)(B), there are two easy solutions to avoid 737 gain. The partnership can either (a) distribute the built-in gain property back to the contributing partner (although it is unclear whether such exception applies to such partner's assignee), or (b) wait seven (7) years after the contributing partner makes a contribution before making distributions of property with built-in gain to such partner.

4. <u>Summary of Major Tax Traps</u>. As noted above, if a distribution results in the application of Sections 731(c) and one or both of Sections 704(c)(1)(B) and 737, the Treasury Regulations provide that the effect of the distribution is determined by applying Section 704(c)(1)(B) first, Section 731(c) second and finally Section 737.

In applying Section 704(c)(1)(B) first, a contributing partner must recognize built-in gain (or loss) from the contributed property if it is ***distributed to another partner*** within seven (7) years of contribution. The "return to sender" exception keeps the contributing partner or the contributing partner's assignee from recognizing any built-in gain (or loss) upon a distribution of the contributed property back to the contributing partner or his or her assignee.

Next, in applying Section 731(c), this section requires ***marketable securities*** distributed to a partner to be treated as a distribution of cash. Accordingly, under Section 731(a), a distribution of cash or marketable securities will be taxable to the extent such distribution exceeds the recipient's outside basis in the partnership. Similar to that of Section 704(c)(1)(B), a "return to sender" exception to Section 731(c) keeps marketable securities from being treated as cash so long as they are distributed to the contributing partner, but it is unclear whether such exception is applicable to the contributing partner's assignee.

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[17] Treas. Reg. 1.731-1(c)(2)(iii).

[18] Treas. Reg. 1.731-2(d)(1).

[19] Donaldson, *supra* 4.

Lastly, in applying Section 737, a contributing partner must recognize built-in gain (but not loss) from the contributed property if such partner ***receives non-cash property*** within seven (7) years of contributing property to the partnership. As is the case with Section 704(c)(1)(B) and Section 731(c), a "return to sender" exception keeps the contributing partner from recognizing any built-in gain upon a distribution of the contributed property back to the contributing partner, but it is unclear whether such exception is available to the contributing partner's assignee. Note, as discussed above, Section 704(c)(1)(B) and Section 737 are symbiotic and work together to prevent partnerships from effecting tax-free exchanges of property with built-in gain. Thus, it can be argued that such sections would also work together to provide the same "return to sender" exception to a contributing partner's assignee.

As the forgoing paragraphs indicate, partners may have a preference between a pro-rata or non-pro-rata liquidation of the partnership from a purely tax perspective. In contrast, non-tax factors (e.g. the desire to own a particular asset because of future growth or income possibilities) may play as big a role to some individuals as the tax implications. Thus, some or all of the partners may wish to overlook the tax implications in determining how to distribute assets in liquidation of the partnership.