PARTNERSHIP TERMINATIONS:

BREAKING UP IS HARD TO DO

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Introduction

The Internal Revenue Service's attacks on family partnerships[2] are testaments to their popularity and value as estate planning vehicles. As is true of revocable trusts, family partnerships follow a life cycle of formation, funding, operation and dissolution. Not too many years ago, the Delaware Tax Institute's sessions on family partnerships focused on the birth of family partnerships, addressing formation and funding issues. Recent professional commentary, including that presented at this Delaware Tax Institute, has largely shifted to the difficult teenage years. Family partnership "parents" are being forced to defend the family partnership from the seemingly relentless barrage of Internal Revenue Service theories devised to overcome valuation discounts.

The successful defense of the family partnership is not the end of the road. At some time, our clients' family partnerships will mature and no longer serve the objectives for which they were formed. Or, perhaps, for whatever reason, a family member will withdraw from the family partnership. This material is directed to the tax

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[1] Copyright 2003, 2004 Bryan E. Keenan. The author gratefully acknowledges the assistance of Michael M. Gordon, a law clerk with Gordon, Fournaris, & Mammarella P.A. All mistakes are those of the author.

[2] For convenience, the term "partnerships" is used to encompass state law general partnerships, limited partnerships and limited liability companies that are partnerships for federal tax purposes.

consequences of terminating interests in family partnerships.[3] As tax sage Neil Sedaka once wrote, "breaking up is hard to do."

Consider a common case. Surviving parent established a family partnership to hold significant wealth, in the form of real estate and marketable securities. During surviving parent's life, surviving parent made gifts of interests in the family partnership to surviving parent's two children. Following the death of the surviving parent, the Internal Revenue Service examined the parent's federal estate tax return. The examination concluded with an agreed 30 percent discount from net asset value for the partnership interests included in surviving parent's estate. During the course of the estate administration, the children begin to develop irreconcilable differences concerning the investment strategy for the family partnership. Following receipt of the closing letter, the children decide to terminate the partnership and distribute the assets to themselves.

The Basic Rules

The basic rules are simple:

1. Gain is recognized by a distributee partner only to the extent of money received in excess of basis.[4]

[3] Recent articles on this topic include Richard B. Robinson, *"Don't Nothing Last Forever" – Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 302 (2003); Ellen K. Harrison and Brian M. Blum, *A Response to Richard Robinson's "Don't Nothing Last Forever" – Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 313 (2003); Richard B. Robinson, *Comments on Blum's and Harrison's "Another View"*, 28 ACTEC J. 318 (2003); Carmen, *Unwinding the Family Limited Partnership: Income Tax Impact of Scratching the Pre-Seven Year Itch*, J. TAX'N. (2002).

2. Loss is recognized by a distributee partner only on the receipt of money, unrealized receivables and inventory.[5]

3. Any gain or loss recognized is deemed to be gain or loss from the sale or exchange of the partnership interest of the distributee partner.[6]

4. A partnership does not recognize gain or loss on a distribution to a partner of property, including money.[7]

Turning back to the prior example, if the partnership's assets do not include cash, under the general rules there will be no gain or loss. However, gain recognition may be triggered under other provisions of Subchapter K.

Deemed Distributions of Cash

Code Section 752(b) Relief of Liabilities Gain

Under Section 752(b) of the Code, a constructive distribution of cash arises if a partner is relieved of any part of his or her share of partnership liabilities.

Assume that parents and their two children are equal partners in a family partnership. The partnership holds real estate, subject to a mortgage of four million dollars. Each partner's adjusted basis in his or her partnership interest is $500,000. If

[4] Code § 731(a)(1). Advances and drawings during the taxable year are treated as being made on the last day of the year. Treas. Reg. § 1.731-1(a)(1)(ii). Cash distributions should be made before property distributions to preserve basis. McKee, Nelson & Whitmire, TAXATION OF PARTNERS AND PARTNERSHIPS, ¶ 19.03[3].

[5] Code § 731(a)(2).

[6] Code § 731(a)(2) flush language.

[7] Code § 731(b).

Child A abandons her interest, she has a constructive distribution of one million dollars (25 percent of four million dollars). Because Child's A adjusted basis in her interest is $500,000, Child A realizes a gain of $500,000.

Code Section 731(c) Marketable Securities Gain

Marketable securities are treated the same as money for the purposes of recognizing gain (but not loss), unless the partnership is an investment partnership.[8] Therefore, in many cases a distributee partner will recognize gain if the distributee partner receives marketable securities.

Marketable securities are financial instruments and foreign currencies that are, as of the date of the distribution, actively traded.[9] The term includes any financial instrument readily convertible into or exchangeable for money or marketable securities,[10] precious metals[11] and interests in any entity substantially all of the assets of which consist (directly or indirectly) of marketable securities, money, or both.[12]

There is a gain limitation rule.[13] The distributee partner's gain is reduced by the excess of that partner's distributive share of the net gain inherent in all the marketable securities held by the partnership before the distribution over that partner's distributive

[8] Code § 731(c)(1)(A).

[9] Code § 731(c)(2)(A).

[10] Code § 731(c)(2)(B)(ii).

[11] Code § 731(c)(2)(B)(iv).

[12] Code § 731(c)(2)(B)(v).

[13] Code § 731(c)(3)(B).

share of the net gain inherent in all the marketable securities held by the partnership after the distribution.

The Treasury Regulations provide the following example of the gain limitation:

A and B form partnership AB as equal partners. AB subsequently distributes Security X to A in a current distribution. Immediately before the distribution, AB held securities with the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security X	100	70	30
Security Y	100	80	20
Security Z	100	110	(10)

If AB had sold the securities for fair market value immediately before the distribution to A, the partnership would have recognized $40 of net gain ($30 gain on Security X plus $20 gain on Security Y minus $10 loss on Security Z). A's distributive share of this gain would have been $20 (one-half of $40 net gain). If AB had sold the remaining securities immediately after the distribution of Security X to A, the partnership would have $10 of net gain ($20 of gain on Security Y minus $10 loss on Security Z). A's distributive share of this gain would have been $5 (one-half of $10 net gain). As a result, the distribution resulted in a decrease of $15 in A's distributive share of the net gain in AB's securities ($20 net gain before distribution minus $5 net gain after distribution). Under the gain limitation rule, the amount of the distribution of Security X that is treated as a distribution of money is reduced by $15. The distribution of Security X is therefore treated as a distribution of $85 of money to A ($100 fair market value of Security X minus $15 reduction).[14]

If the distribution is in complete liquidation of the partner's interest in the partnership, the gain limitation equals the distributee partner's distributive share of the net gain inherent in all the marketable securities held by the partnership before the distribution.

The rule treating marketable securities as money does not apply if the distributee partner contributed the securities to the partnership.[15] The Treasury Regulations do not provide that a transferor partner is treated as a contributing partner, nor do they incorporate such a rule by reference.

The rule treating marketable securities as money does not apply to a distribution by an investment partnership to an eligible partner.[16] An investment partnership for most purposes is a partnership not engaged in a trade or business, substantially all of the assets of which are cash and financial instruments.[17] The Treasury Regulations apply a 90 percent test of substantiality at the time of distribution.[18] An eligible partner is a partner who contributed only investment type assets or investment type assets and services to the partnership.[19]

[14] Treas. Reg. § 1.731-2(j), Ex. 2.

[15] Code § 731(c)(3)(A)(i).

[16] Code § 731(c)(3)(A)(iii).

[17] Code § 731(c)(3)(C)(i).

[18] Treas. Reg. § 1.731-2(c)(3).

[19] Code § 731(c)(3)(C)(iii).

Returning to the original example, if the marketable securities make up 90 percent or more of the assets of the partnership at the time of distribution, the marketable securities will not be treated as cash.

Distributions of Contributed Appreciated Property

Section 704(c)(1)(B) Contributed Property Gain

A partner who contributed Code Section 704(c) property to the partnership will recognize gain if the contributed property is distributed *to another partner* of the partnership (that is, to a partner other than the contributing partner). Code Section 704(c) property is property with inherent gain (or loss) when contributed to the partnership. The distribution must be within seven years of the contribution in order to trigger recognition of gain by the contributing partner.[20] *The contributing partner* (or his or her successor) must recognize the unrecognized gain (or loss) remaining as of the distribution as if the partnership sold property at its then fair market value.[21]

Returning to the example, assume that the assets contributed by surviving parent were appreciated when contributed to the partnership and that they were contributed within seven years of the distribution. Because the distributee partners received their interests from the contributing partners, the distributee partners are all considered contributing partners[22] and, therefore, there is no Section 704(c)(1)(B) gain.

[20] Code § 704(c)(1)(B) (five years for distributions before June 9, 1997).

[21] Code § 704(c)(1)(B).

[22] Treas. Reg. § 1.704-4(d)(2).

Assume, instead, that the partnership distributes an undeveloped real estate parcel to one of the partners when surviving parent holds a 50 percent interest and each child holds a 25 percent interest in the partnership. The parcel was contributed by surviving parent on formation of the partnership and its fair market value was greater than its adjusted basis at the time of contribution (that is, there was built-in gain). At the time of distribution there is $100,000 of built-in gain remaining. Here, the distributee partner is treated as the contributing partner only as to his or her 25 percent. Thus, the surviving parent has recognized $50,000, and the other child has recognized $25,000, of Code Section 704(c)(1)(B) gain.

Code Section 737 Contributed Property Gain

A distributee partner will recognize gain if the distributee partner receives a distribution of appreciated property and previously contributed other appreciated property to the partnership. The distribution must be within seven years of the contribution.[23] The recognized gain is the lesser of (i) the distributee partner's remaining unrecognized pre-contribution gain or (ii) the excess of the property's fair market value over the distributee partner's adjusted basis in his or her partnership interest (the "excess distribution").[24] Pre-contribution gain is the Code Section 704(c)(1)(B) gain that would be allocated to that partner if ***all*** of the property contributed by that partner in the prior seven years had been distributed to another

[23] Code § 737(b)(1) (five years for distributions before June 9, 1997). The Treasury Regulations under Code Section 737 have not be amended to reflect the longer time period.

[24] Code § 737(a). The partner's adjusted basis in his or her partnership interest must be first adjusted for distributions of cash or deemed cash. *See* Treas. Reg. § 1.737-1(b)(3)(i).

partner.[25] Property that is part of the distribution and that was originally contributed by the distributee partner is excluded in calculating the excess distribution and pre-contribution gain.[26]

Assume two partners each contribute an undeveloped appreciated parcel of real estate to a three person partnership, while the third partner contributes cash.

Assets	**Adj. Basis**	**FMV Contribution**	**FMV Distribution**
Parcel A	$50,000	$100,000	$200,000
Parcel B	$60,000	$100,000	$150,000
Cash	$100,000	$100,000	$100,000
Capital			
Partner A	$50,000	$100,000	
Partner B	$60,000	$100,000	
Partner C	$100,000	$100,000	

If Parcel A, contributed by Partner A, is distributed by the partnership to Partner B within seven years of its contribution (and there has been no other partnership activity), the excess distribution to Partner B equals the $200,000 fair market value of the distributed property less the $60,000 adjusted basis in partnership interest, or $140,000. The net pre-contribution gain equals the $100,000 fair market value of the contributed property at the time of contribution less the $60,000 adjusted basis, or $40,000. Partner B's recognized Code Section 737 Gain is $40,000, the lesser of the excess distribution of $140,000 and the net pre-contribution gain of $40,000.

[25] Code § 737(b).

[26] Code § 737(d)(1).

Clearly, Code Section 737 gain must be considered when a family partnership distributes appreciated property to one partner. But, what if the family partnership is liquidating, so that each partner is receiving his or her share of contributed property? If transferee partners are considered the contributing partner for purposes of Code Section 737, the entire distribution will be excluded and net pre-contribution gain will be zero. Because the Code Section 737 gain test is a "lesser of" test, there will be no Code Section 737 gain.

The Treasury Regulations under Code Section 737 do not explicitly provide that transferee partners will be considered to be the contributing partner. However, by cross-reference to Treasury Regulations Section 1.704-4, the Treasury Regulations under Code Section 737 incorporate by reference the "step in the shoes" rule.[27] Therefore, when a family partnership is liquidated where all partners share proportionally in Code Section 704 property, Code Section 737 gain will be zero.[28]

Code Section 751 Disproportionate Distribution Gain

Gain will be recognized where the distribution is a disproportionate distribution altering the partners' interests in Code Section 751 property. If the distributee receives less Code Section 751 property in the distribution than his or her proportional interest in

[27] Treas. Reg. § 1.737-1(c)(1). The step in the shoes rule is Treasury Regulations Section 1.704-4(d)(2).

[28] *Accord*, McKee, Nelson & Whitmire, TAXATION OF PARTNERS AND PARTNERSHIPS, ¶ 19.08[2][e], n. 153; Ellen K. Harrison and Brian M. Blum, *A Response to Richard Robinson's "Don't Nothing Last Forever" – Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 313 (2003). *Contra*, Richard B. Robinson, *"Don't Nothing Last Forever" – Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 302 (2003); Richard B. Robinson, *Comments on Blum's and Harrison's "Another View"*, 28 ACTEC J. 318 (2003); Carmen, *Unwinding the Family Limited Partnership: Income Tax Impact of Scratching the Pre-Seven Year Itch*, J. TAX'N. (2002).

the partnership's Code Section 751 property, the distributee is deemed to have received the Code Section 751 property and sold it to the partnership, generating ordinary income. The situation of the parties is reversed where the distributee partner receives excess Code Section 751 property.

Code Section 751 property is property generating ordinary income – unrealized receivables and substantially appreciated inventory items.

Code Section 707 Disguised Sale Gain

Gain may be recognized where the distributee partner transferred property to the partnership within two years of the distribution (or the distribution is otherwise part of a disguised sale). A disguised sale involves the transfer of money or property by a partner to the partnership and a related transfer of money or property to the contributing partner or any other partner.[29] Each case turns on its own facts and circumstances.[30]

The transfers may occur in order, contribution followed by distribution or distribution followed by contribution. The sale is deemed to take place on the date the partnership takes title to the property.[31]

Generally, a disguised sale involves a disproportionate distribution to the "selling" or "buying" partner.

[29] Code § 707(a)(2)(B).

[30] Treas. Reg. § 1.707-3(b)(2).

[31] Treas. Reg. § 1.707-3(a)(2).

If, within a two-year period, a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a disguised sale unless the facts and circumstances clearly establish otherwise.[32]

The Treasury Regulations provide the following example:

A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in the partnership. At the time of the transfer, property X has a fair market value of $4,000,000 and an adjusted tax basis of $1,200,000. One year after A's transfer of property X to the partnership, the partnership transfers $3,000,000 in cash to A. Assume that the applicable Federal short-term rate for April, 1992, is 10 percent, compounded semiannually.

A and the partnership are treated as if, on April 9, 1992, A sold a portion of property X to the partnership in exchange for an obligation to transfer $3,000,000 to A one year later. Section 1274 applies to this obligation because it does not bear interest and is payable more than six months after the date of the sale. As a result, A's amount realized from the receipt of the partnership's obligation will be the imputed principal amount of the partnership's obligation to transfer $3,000,000 to A, which equals $2,721,088 (the present value on April 9, 1992, of a $3,000,000 payment due one year later, determined using a discount rate of 10 percent, compounded semiannually). Therefore, A's amount realized from the receipt of the partnership's obligation is

[32] Treas. Reg. § 1.707-3(c)(1).

$2,721,088 (without regard to whether the sale is reported under the installment method). A is therefore considered to have sold only $2,721,088 of the fair market value of property X. The remainder of the $3,000,000 payment ($278,912) is characterized in accordance with the provisions of section 1272. Accordingly, A must recognize $1,904,761 of gain ($2,721,088 amount realized less $816,327 adjusted tax basis ($1,200,000 multiplied by $2,721,088/$4,000,000)) on the sale of property X to the partnership. The gain is reportable under the installment method of section 453 if the sale is otherwise eligible. Assuming A receives no other transfers that are treated as consideration for the sale of property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,278,912 of the fair market value of property X with an adjusted tax basis of $383,673.[33]

Distribution Checklist

- Does the amount of cash distributed exceed the partner's adjusted basis in his or her partnership interest? [Code Section 731(a)(1)]
- Does the distribution result in a decrease in the distributee partner's share of liabilities? [Code Section 752(b)]
- Does the distribution include marketable securities? [Code Section 731(c)(2)(A)]
- Does the gain limitation rule reduce the recognized gain? [Code Section 731(c)(3)(B)]
- Did the distributee partner contribute the securities to the partnership? [Code Section 731(c)(3)(A)(i)]

[33] Treas. Reg. § 1.707-3(f), Ex. 2.

- Is the distributing partnership an investment partnership? [Code Section 731(c)(3)(C)(i)]

- If the distributing partnership is an investment partnership, is the distributee partner an eligible partner? [Code Section 731(c)(3)(C)(iii)]

- Does the distribution include any property contributed by another partner to the partnership within the past seven years? [Code Section 704(c)(1)(B)]

- Does the distribution include appreciated property and the distributee partner previously contributed other appreciated property to the partnership in the past seven years? [Code Section 737]

- Does the distribution alter the partner's interests in "Code Section 751 property"? [Code Section 751]

- Is the distribution within two years of a contribution to the partnership? [Code Section 707]

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