INCOME TAX ASPECTS OF FAMILY LIMITED PARTNERSHIPS

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This outline considers many of the federal income tax aspects of family limited partnerships and family limited liability companies (collectively "FLPs"). This is not the first careful examination of these issues,[1] but it attempts to provide a summary reference for the estate planning professional. Estate planners often focus on the federal and state wealth transfer tax advantages to be gained from the use of FLPs, but they sometimes neglect to consider the income tax consequences associated with these entities.

I. FORMATION OF THE FLP

A threshold issue for the new FLP is its characterization for federal tax purposes. As an unincorporated entity engaged in an activity for profit with two or more members, an FLP will by default be treated as a partnership. But the owners of the FLP can elect to have the entity treated as a corporation. Most every FLP will cling to partnership treatment, however, for three important reasons.

First, corporations are still subject to a "double tax" on entity income. Undeniably, the significance of the double tax has become less significant now that most dividend distributions are taxed at the same rate as long-term capital gains. Still, it exists. The double tax can be mitigated to some extent through a subchapter S election, but even for S corporations there is recognition of gain upon distributions of appreciated property, a result that does not necessarily apply to partnerships. *Second*, corporations lack the flexibility of partnerships in making special allocations of income, gain, loss, deduction, and credit items. It turns out that most FLPs do not make special allocations of tax items anyway in order to preserve their transfer tax benefits, but once the founding partners are out of the picture and the beneficiary partners are left with complete ownership of the entity, the ability to be flexible is attractive. *Third*, shareholders do not get any basis credit for the debts of the corporation, while partners of a partnership get basis credit for the partnership's debts. Added basis credit helps in deducting losses of the partnership.

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[1] See, e.g., Carol Cantrell, *Income Tax Problems When the Estate or Trust is a Partner*, ALI-ABA COURSE OF STUDY MATERIALS, PLANNING TECHNIQUES FOR LARGE ESTATES (April 2010); Samuel A. Donaldson, *Super-Recognition and the Return-to-Sender Exception: The Federal Income Tax Problems of Liquidating the Family Limited Partnership*, 35 CAP. U. L. REV. 15 (2006); Scott Bieber, Robert R. Pluth, Jr., Katherine J. Levy, and Theodora P. Karnegis, *Tax Effect of Redeeming a Partnership Interest*, 31:10 ESTATE PLANNING 505 (October 2004); Mark P. Gergen, *Potential Tax Traps in Liquidating a Family Limited Partnership*, 101 TAX NOTES 1431 (December 22, 2003); Thomas I. Hausman, *Mixing Bowls and Marketable Securities in a Family Limited Partnership*, 101 TAX NOTES 373 (October 20, 2003); Richard B. Robinson, *"Don't Nothing Last Forever"—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 302 (2003); Louis A. Mezzullo, *Family Limited Partnerships and Limited Liability Companies*, ALI-ABA COURSE OF STUDY MATERIALS, ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER (July 2003); Michael V. Bourland, Kenneth L. Wenzel, P. Michelle Eaton, and Stephanie M. Bourland, *Hot Topics Under the 2001 Tax Act and Transfer Planning: Maintaining/ Operating the Family Limited Partnership*, ALI-ABA COURSE OF STUDY MATERIALS, ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER (August 2002); Paul Carman, *Unwinding the Family Limited Partnership: Income Tax Impact of Scratching the Pre-Seven-Year Itch*, 96 J. TAX'N 163 (2002); David Keene, *Beyond Valuation Discounts: What You Should Know and Tell Your Clients About FLPs and LLCs*, in Materials from Understanding Business Entities in the Estate Planning Area, Washington State Bar Association CLE #01447B (February, 2001).

Assuming the entity will remain a partnership for federal tax purposes, the number of tax issues at formation of the FLP are relatively few. Founding partners must be aware of the risk of gain recognition under §§ 721(b) and 752, though this risk can be avoided fairly easily with proper planning. Also as part of formation, the founding partners must consider the FLP's appropriate tax year and accounting method.

A. Investment Company Partnerships [§ 721(b)]

1. Gain Recognition

Generally, the formation of an FLP is not a taxable event, as § 721(a) provides nonrecognition of gain or loss on the contribution of property to the FLP in exchange for an interest in the FLP's capital. Section 721(b), however, requires recognition of gain (but not loss) in certain cases where the FLP would be treated as an "investment company" under § 351 if the FLP were taxed as a corporation. A corporation is treated as an investment company if more than 80% of the value of its assets consists of "portfolio assets" (generally, stocks, securities, cash, notes, options, foreign currency, certain financial instruments, interests in real estate investment trusts, and ownership interests in entities holding such assets) held for investment. If a shareholder's contribution of property to an investment company results in diversification of the shareholder's capital interest, the shareholder must recognize gain.

In the FLP context, then, a transfer of investment assets in exchange for a capital interest in the partnership can be taxable if the transfer diversifies the contributing partner's investment.

> EXAMPLE (1): Mom and Daughter decide to form an FLP to be taxed as a partnership. Mom transfers stock in ABC Corporation (worth $800,000) to the FLP in exchange for a 4% general partner interest and a 76% limited partner interest. Daughter transfers $200,000 cash to the FLP in exchange for a 1% general partner interest and a 19% limited partner interest. Because more than 80% of the value of FLP's assets consists of portfolio assets (remember that cash is a portfolio asset under this rule), FLP would be considered an investment company if it were taxed as a corporation. Because the transfers by Mom and Daughter result in the diversification of their investments (the parties transferred non-identical assets to FLP in exchange for the interests[2]), Mom and Daughter must recognize any realized gain, but do not recognize any realized loss.

2. Planning to Avoid § 721(b)

The easiest way to avoid the application of § 721(b) is to make sure that marketable securities and other portfolio assets comprise no more than 80% of the total value of the assets to be contributed to the partnership. Assets like real estate and collectibles do not count as portfolio assets, and their contribution to an FLP helps in avoiding § 721(b).[3] As will be explained later, however, contributing non-portfolio assets to the FLP will increase the risk of gain recognition upon a distribution of marketable

[2] Treas. Reg. § 1.351-1(c)(5).

[3] Yet we will see that avoidance of § 721(b) through the transfer of non-portfolio assets may make it difficult to distribute any portfolio assets out of the partnership without recognition of gain. See Part III(B)(3) *infra*.

securities from the FLP to any partner other than the contributing partner. So this easy technique is not without some wrinkles.

What about the client who lacks a sufficient amount of non-portfolio assets? There are three ways to avoid the application of § 721(b) for these clients, each of which involves some planning prior to formation of the entity. *First*, if the founding partners are married, the planner could have each partner transfer an undivided one-half interest in all of the assets to be transferred to the FLP. Any transfers made between the founding partners in anticipation of the FLP's formation will not give rise to adverse tax consequences,[4] so these "equalizing" transfers are an easy way to ensure neither partner's interest is diversified by formation of the entity.

> EXAMPLE (2): Husband and Wife, residents of a separate property state,[5] decide to form an FLP to hold Husband's stock in ABC Corporation (worth $500,000) and Wife's notes from various debtors (also worth $500,000). If each spouse transfers his or her assets to the FLP in exchange for a 50% interest in the FLP, then because more than 80 percent of the value of FLP's assets consists of portfolio assets, FLP would be considered an investment company if it were taxed as a corporation. Furthermore, because the transfers by Husband and Wife result in the diversification of their investments (the parties transferred non-identical assets to FLP in exchange for the interests, as in Example (1) above), Husband and Wife would recognize any realized gain, but would not recognize any realized loss. To avoid this result, Husband should convey an undivided one-half interest in the ABC stock to Wife, and Wife should convey an undivided one-half interest in the notes to Husband. Then, each spouse would transfer a one-half interest in all of the assets to the FLP in exchange for a 50% interest in the entity. Since each partner contributes identical assets to the entity in exchange for a proportionate interest in the entity, there is no diversification of any partner's investment and, thus, § 721(b) does not apply.

Second, if the founding partners are unmarried, the planner can advise each founding partner to contribute substantially identical assets to the FLP. Where one partner controls the other partner (like where the two partners are a corporation and its sole shareholder), equalization of the contributions in this context is generally feasible. In considering this option, planners should remember that "insignificant" transfers of non-identical assets can be ignored for purposes of determining whether diversification has occurred.[6] Treasury has formally stated that where a founding partner contributes non-identical assets worth only 0.99% of the total amount transferred to the entity at formation, the *de minimis* contribution

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[4] Transfers between spouses do not give rise to recognized gains or losses, and the transferee spouses take the transferor spouse's basis in the property transferred. I.R.C. § 1041. Such transfers also qualify for the unlimited marital deduction for federal gift tax purposes. I.R.C. § 2523. Accordingly, there is no tax consequence to any intra-spousal transfer of property.

[5] If they resided in a community property state, no pre-formation equalization of assets may be required by operation of community property laws.

[6] Treas. Reg. § 1.351-1(c)(7), Ex. (1).

could be ignored.[7] Informally, the Service has ruled that a transfer of non-identical assets comprising less than 5% of total value contributed at formation is likewise insignificant.[8] Beyond that, one is left to guesswork, although the Service has ruled that a transfer of non-identical assets worth 11% of the total contribution at formation is *not* insignificant.[9]

> EXAMPLE (3): Mom forms Private Corporation by transferring stock in Public Corporation (worth $600,000) in exchange for all of Private Corporation's stock. Mom, Private Corporation, and Daughter then decide to form an FLP to be taxed as a partnership. Mom transfers additional stock in Public Corporation (worth $390,000) to the FLP in exchange for a 39% limited partner interest. Private Corporation transfers all of its holdings in Public Corporation to the FLP in exchange for a 1% general partner interest and a 59% limited partner interest. Daughter transfers $10,000 cash to FLP in exchange for a 1% limited partner interest. Because Daughter's contribution is only one percent of the total consideration transferred to FLP at formation, her non-identical contribution of cash is ignored for purposes of determining whether any partner has diversified under § 721(b). Moreover, since Mom and Private Corporation each contributes identical assets to FLP in exchange for a proportionate interest in the entity, there is no diversification of any partner's investment and, thus, § 721(b) does not apply.

Finally, perhaps the best solution to avoiding § 721(b) is to have each partner transfer already-diversified portfolios to the FLP at formation. Treasury says no diversification occurs if each partner transfers a diversified portfolio of stocks and securities.[10] A contributing partner's portfolio is diversified if no more than 25% of the portfolio's value is invested in any one issuer and if no more than half of the value of the portfolio is invested in five or fewer issuers.[11] For purposes of this rule, government securities count as part of the value of the portfolio but are not considered to be securities of an issuer.

> EXAMPLE (4): Mom and Daughter decide to form an FLP to be taxed as a partnership. Mom transfers stock in ten blue-chip, publicly traded corporations (worth a total of $800,000) to the FLP in exchange for a 4% general partner interest and a 76% limited partner interest. Daughter transfers stock in ten different publicly traded corporations (worth a total of $200,000) to the FLP in exchange for a 1% general partner interest and a 19% limited partner interest. No one issuer comprises more than 25% of the value of either partner's portfolio. Although more than 80% of the value of FLP's assets consists of portfolio assets, § 721(b) does not apply because each partner contributed a diversified portfolio of marketable securities.

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[7] Id.

[8] Private Letter Ruling 200006008.

[9] Rev. Rul. 87-9, 1987-1 C.B. 133.

[10] Treas. Reg. § 1.351-1(c)(6).

[11] I.R.C. § 368(a)(2)(F)(ii).

In any case where portfolio assets will dominate an FLP's holdings and more than one person will be a founding partner, the founders must be careful not to trigger § 721(b). Hopefully, a satisfactory answer lies in at least one of the above suggestions.

B. Contributions of Encumbered Property [§ 752]

While § 721 generally provides that no partner recognizes gain upon the transfer of money or other property to a partnership in exchange for an interest in the partnership, a partner *may* recognize gain if any debt or encumbrance attached to the contributed property exceeds the partner's adjusted basis in such property. That is because § 752(b) treats a reduction in a partner's share of partnership liabilities as a cash distribution to such partner, and § 731 generally provides that a cash distribution is taxable to the extent it exceeds a partner's basis in his or her partnership interest (the partner's "outside basis"). Since a partner's outside basis is determined with reference to the adjusted basis of the property contributed to the partnership in exchange for the interest, gain recognition is a distinct possibility where the amount of the debt exceeds the contributing partner's basis in the underlying property.

Of course, if the entire debt is allocated to the contributing partner under the regulations to § 752, there is no deemed cash distribution to the contributing partner. Thus, gain recognition is not a certainty whenever debt exceeds basis, but the chance of recognition should cause planners to proceed with caution.

If the amount of debt exceeds the *value* of the contributed property (that's some contribution!), additional issues arise. Most notably, § 752(c) limits the contributing partner's outside basis to the value of the contributed property, even if all of the property's debt is allocated to the contributing partner under the § 752 regulations.

C. Use of the Cash Method

So long as the chosen method of accounting clearly reflects income, FLPs are free to use the cash method, the accrual method, or any combination of the two methods.[12] There are three important limits in this regard.

First, an FLP with a C corporation partner (a common technique prior to the popular ascension of the LLC was to incorporate the general partner of an FLP to insure limited liability to all partners) cannot use the cash method unless its average annual gross receipts for a three-year period do not exceed $5 million or unless the FLP is engaged in the business of farming. The vast majority of FLPs do not generate more than $5 million in average annual gross receipts over a three-year period, so this restriction applies to few entities.

Second, an FLP cannot use the cash method if it constitutes a "tax shelter."[13] The term "tax shelter" is broadly defined to encompass any entity "if a significant purpose of such [entity] is the

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[12] I.R.C. § 446(c).

[13] I.R.C. § 448(a)(3).

avoidance or evasion of Federal income tax."[14] Most FLPs are not designed to avoid federal income taxes, but this broad definition might give pause to planners in cases where the FLP might be expected to generate losses. If the Service determines that a *significant* (not "principal" but presumably more than "incidental") purpose of the FLP arrangement is to avoid federal income taxes, the entity may be prohibited from using the cash method.[15] Even if the FLP is not a tax shelter, it may qualify as a "syndicate," and thus prohibited from use of the cash method.[16] A syndicate is a partnership where more than 35% of its losses are allocated to limited partners who do not actively participate in the partnership's management.

Third, an FLP may not use the cash method if and to the extent it purchases and sells inventories. Because the plain-vanilla FLP does not engage in the manufacture, purchase, or sale of inventory, an extensive discussion of the inventory accounting rules is omitted here. The key for now is to recognize that the cash method may not be available to the FLP in all events.

II. OPERATION OF THE FLP

Once the FLP is up and running, the benefits of pass-through taxation become apparent. The FLP is not liable for any tax on its taxable income; instead, such income is treated as the income of the partners. Subsequent distributions of the income from the FLP are generally tax-free, resulting in a single layer of tax on the FLP's income. Of course, the devil is in the details; indeed, some of the exceptions and limitations applicable to this general scheme of pass-through taxation are downright satanic.

A. Income and Deduction Allocations

1. Generally

Partners are generally free to allocate the income, gain, loss, deduction, and credit items of the FLP among themselves however they may agree, subject to the constraint in § 704(b) that such allocations have "substantial economic effect." Detailed regulations give guidance for ensuring that allocations meet this amorphous standard. The regulations provide two safe harbors under which an allocation will be deemed to have "economic effect."[17] Both safe harbors require the FLP to maintain capital accounts using

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[14] I.R.C. §§ 448(d)(3); 461(i)(3); 6662(d)(2)(C)(iii).

[15] Though that is probably the least of the planner's (and partners') concerns.

[16] I.R.C. §§ 448(a)(3); 461(i)(3)(B); 1256(e)(3)(B).

[17] Treas. Reg. § 1.704-1(b)(2)(ii). The first safe harbor applies where the partnership agreement requires: (1) the determination and maintenance of capital accounts in accordance with specific rules provided elsewhere in the regulations; (2) that liquidating distributions be made in accordance with the positive capital account balances of the partners; and (3) that any partner with a deficit balance in his or her capital account at liquidation be required to restore the deficit balance to the partnership within a stated period. Treas. Reg. § 1.704-1(b)(2)(ii)(b). The second safe harbor applies where the partnership agreement requires: (1) both of the first two conditions of the first safe harbor (maintenance of capital accounts according to specific rules and liquidating distributions according to positive capital account balances); (2) the operation of a "qualified income offset" provision; and (3) that no allocation to a partner may cause or increase a deficit balance to that partner's capital account in an amount

specific accounting rules set forth in the regulations.[18] In some cases, compliance with these accounting rules proves to be difficult (i.e., expensive). Because the typical FLP arrangement does not involve the use of special income or deduction allocations (indeed, the use of special allocations might run afoul of § 2701[19] or § 704(e)[20]), it might be better *not* to follow the capital account rules in the regulations, provided the FLP agreement requires all allocations to be in accordance with the partners' interests in the partnership. Remember: failure to fall within one of the two safe harbors for economic effect means only that the Service can reallocate items if it determines that an allocation with not made in accordance with the partners' interests in the partnership. It does not mean that all allocations are *per se* invalid.

2. Special Rule for Family Partnerships [§ 704(e)(2)]

Section 704(e)(2) states that where there has been a gift of a limited partner interest in an FLP, the recipient's distributive share of the FLP's income is limited in two ways. *First*, the donor must be adequately compensated for any services rendered to the FLP. In other words, the donor cannot perform services at no charge for the FLP and pass along the savings to the recipient.

> EXAMPLE (5): Dad gives Daughter a 40% limited partner interest in FLP, retaining a 10% general partner interest and a 50% limited partner interest. The FLP's taxable income for the year is $100,000. In that same year, Dad performed services for FLP valued at $40,000. An allocation of $40,000 of the $100,000 taxable income to Daughter would violate § 704(e)(2) because it does not consider the services performed by Dad. Instead, the $40,000 in services should be treated as compensation to Dad, leaving $60,000 to be allocated according to the partner's interest in the partnership. In sum, Dad would be allocated income totaling $76,000 ($40,000 for Dad's services plus 60% of the partnership's remaining $60,000 income, or $36,000), while Daughter would be allocated $24,000 of income (40% of the partnership's $60,000 income after services).

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greater than the amount that partner is obligated to restore upon liquidation of the entity. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

[18] Treas. Reg. § 1.704-1(b)(2)(iv).

[19] Section 2701 values certain retained interests in an FLP at zero for purposes of valuing subordinate equity interests transferred to certain family members. If all interests in an FLP have identical distribution and liquidation rights, § 2701 does not apply. Accordingly, estate planners usually advise the partners to make sure all income and deduction allocations are made according to the partners' interests in the partnership, regardless of whether such interests have voting or management rights. Differences in voting and management rights (as well as differences in liability for entity debts) do not by themselves create subordinate equity interests, so creating voting and nonvoting partnership interests does not trigger application of § 2701's zero-value rule. Treas. Reg. § 25.2701-1(c)(3).

[20] In an FLP, income must be allocated in a manner proportionate to the capital interests of the partners (after allocating compensation to partners for services rendered to the partnership). Treas. Reg. § 1.704-1(e)(3). See also the discussion *infra* at II(A)(2).

Second, if the recipient's interest was funded with donated capital, the donor and the recipient must be allocated income in proportion to the donated capital. In effect, the maximum income allocable to a recipient partner is the income allocable to the recipient partner's interest in partnership capital.

> EXAMPLE (6): Mom and Dad formed FLP when each contributed investment assets in exchange for general and limited partner interests. Mom and Dad each gave Son a 10% limited partner interest (a total 20% limited partner interest). Under § 704(e)(2), the income allocation to Son must be proportionate to the income allocated to Mom and Dad, so Son must be allocated 20% of the income attributable to the contributed assets. Mom and Dad cannot agree to divert more (or less) income to Son.

Combining the two rules under § 704(e)(2), the regulations state that family partnership income must be distributed proportionate to capital interests after distributing reasonable compensation to the donor for services rendered to the FLP.[21]

3. The Peril of Restricting Transfers and Distributions

Planners seeking maximum marketability discounts for transfer tax valuation purposes are tempted to draft an FLP agreement with all kinds of restrictions on a limited partner's ability to transfer his or her partnership interest. While a limited partner in a regular partnership might normally be required to offer his or her interest to the other partners before selling that interest to a non-partner, limited partners in some FLPs are prohibited from making any transfer of a partnership interest without the consent of the general partners (or, in some cases, all of the general partners *and the other limited partners*). Likewise, planners often try to maximize the minority interest discount for transfer tax valuation purposes by imposing increased restrictions on a limited partner's ability to compel a distribution. Although limited partners in an ordinary partnership arrangement might have the power to compel a distribution by a super-majority vote, limited partners in an FLP may be stripped of this power altogether in order to remove any semblance of control over the management of the FLP's affairs.

While these added restrictions on transfers and distributions can be effective in enhancing the applicable valuation discount, they may come at an income tax cost to the founding partners. Regulations under § 704(e) provide that if a donee-partner's right to transfer his or her partnership interest is subject to "substantial restrictions," or if the donor-partner "retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relationships," the restrictions will be considered "strong evidence" that the donee-partner does not really own the partnership interest.[22] For federal income tax purposes, of course, that means that the donor-partner would be taxed on the donee-partner's share of the FLP's income. This may be an acceptable risk to clients seeking maximum valuation discounts, particularly where the FLP's assets do not yield significant income. But one should be careful about restricting transfers and distributions without considering the potential federal income tax ramifications.

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[21] Treas. Reg. § 1.704-1(e)(3).

[22] Treas. Reg. § 1.704-1(e)(2)(ix).

B. Distributions

Section 731(a)(1) generally provides that no gain is recognized upon a distribution from a partnership except to the extent that any cash received in the distribution exceeds the recipient partner's outside basis immediately prior to the distribution. Thus, to the extent a partner receives an in-kind distribution of property, there is no recognition of gain or loss. The recipient partner generally takes the partnership's basis in distributed property.[23]

Property distributions are treated as cash distributions in two cases. First, to the extent a property distribution reduces a partner's share of partnership liabilities, the reduction is treated as a cash distribution under § 752(b). Second, a distribution of marketable securities will be treated as a distribution of cash in most cases under § 731(c). A detailed examination of § 731(c) appears below in the context of partnership liquidations.

C. Gift Transfers of Partnership Interests

1. Giving the Gift of Basis

No matter how many different types of interests a partner may have in an FLP, and no matter how or when such interests were acquired, each partner for federal income tax purposes has a single outside basis.[24] When a founding partner gives part of his or her entire interest in the FLP to a beneficiary, part of the founding partner's outside basis also carries over to the beneficiary. It is well accepted that the portion of the founding partner's outside basis allocable to the given interest is proportionate to the value of the given interest relative to the value of the founding partner's entire pre-transfer interest.[25] The use of valuation discounts in *inter vivos* gift planning limits the amount of outside basis that carries over to a founding partner's beneficiary.

EXAMPLE (7): Mom and Dad are the general and limited partners of FLP. Each partner has an outside basis of $150,000 ($300,000 total). An expert's appraisal determines the value of the FLP's 5% general partner interest to be $50,000 (or $10,000 for a 1% general partner interest) and the value of the 95% limited partner interest to be $475,000 (or $5,000 for a 1% limited partner interest). Mom and Dad together transfer a total 20% limited partner interest to Son. The discounted value of the gift is $100,000. Son's outside basis in the gifted FLP interest is $57,143, *not* $60,000 (or 20% of their combined $300,000 outside basis), as shown below:

[23] I.R.C. § 732(a)(1). The basis of distributed property may not, however, exceed the recipient partner's outside basis immediately prior to the distribution (reduced by any cash received in the same distribution). I.R.C. § 732(a)(2). Allocation rules are provided in § 732(c) where a partner receives more than one asset and the § 732(a)(2) limitation comes into play.

[24] See, e.g., *Rev. Rul. 84-53*, 1984-1 C.B. 159.

[25] Treas. Reg. § 1.61-6(a).

FMV gift / FMV pre-transfer interests	x	(donor's outside basis)	=	outside basis allocable to gift
$100,000 / $525,000	x	($300,000)	=	$57,143

The result in this Example may not be bad. To the extent the founding partners retain more of their outside basis, a sale of the partnership assets followed by a distribution of the cash proceeds will be taxed more to the beneficiary than to the founding partners. If the beneficiary is in a lower tax bracket, this may result in less tax.[26] Whether the result is good or bad, the practitioner should be careful to apportion the donor's outside basis correctly for purposes of determining the allowable portion of each partner's distributive share of partnership losses[27] as well as the amount of cash that can be distributed to each partner without recognition of gain.[28]

2. Transferring Interests Where Debt Exceeds Basis

Where a donor partner transfers FLP interests subject to liabilities in excess of the outside basis allocable to the transferred interests, the donor partner recognizes gain.[29] To the extent the liabilities remain allocable to the donor partner, however, no gain should be recognized since no portion of the debt is allocable to the transferred interests.

> EXAMPLE (8): Dad owns voting and nonvoting interests in FLP comprising a total 50% interest in the entity. Dad's outside basis for his interests is $50,000, and Dad's share of entity liabilities is $250,000. If Dad transfers a 10% nonvoting interest in FLP to Son, the outside basis allocable to the 10% interest is $10,000, and 10% of the partnership's debts is $50,000. Accordingly, Dad will recognize a gain of $40,000 on the transfer unless Dad is still liable for FLP's debts (e.g., because Dad is the general partner of FLP or because Dad expressly provides that Son does not take his interest subject to the liabilities).

To ensure that no debt travels to the donee along with the gifted interest, donor-partners could transfer the interest to a defective grantor trust.

D. Death of a Partner

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[26] One should also keep in mind that if the gift triggers liability for federal gift tax, the donee will receive additional basis under § 1015(d).

[27] I.R.C. § 704(d).

[28] I.R.C. § 731(a)(1).

[29] Treas. Reg. §§ 1.1001-2(a)(1); 1.1001-2(a)(4); 1.1001-2(c), Example (5).

1. Close of Taxable Year

Upon the death of a partner, § 706(c)(2)(A) provides that the taxable year of the FLP closes with respect to the deceased partner. The deceased partner's final income tax return includes all pass-through items for the short taxable year ending at death, either through an interim closing of the books or through a *pro rata* allocation based on the number of days in each period.[30]

EXAMPLE (9): Mom, Son, and Daughter are equal general and limited partners in FLP. Mom dies on July 1, Year One. FLP's income for Year One consists of two gains: a $900 gain in March and a $300 gain in November. If FLP makes an election to close its books on July 1, the proportionate shares of the partners would be as follows:

Partner	March Gain Share	November Gain Share
Mom	$300	zero
Son	$300	$150
Daughter	$300	$150

If, on the other hand, FLP does not close its books, the proportionate shares of the partners for Year One would be as follows:

Partner	March Gain Share	November Gain Share
Mom	$150	$50
Son	$375	$125
Daughter	$375	$125

In this example, Son and Daughter are inclined to close the books, for their proportionate shares under a closing of the books ($450) is less than their shares if no such election is made ($500). Of course, if the November gain were larger than the March gain, the incentive would be the opposite.

The fiduciary and the surviving partners should work together to determine which approach is better.

2. Adjustment to Basis

If the FLP makes an election under § 754, the FLP's basis in its assets ("inside basis") will be adjusted, but only with respect to the transferee partner. Specifically, the entity will increase its inside basis by the excess of the transferee partner's outside basis (freshly stepped-up under § 1014, mind you) over his or her share of the FLP's inside basis. Alternatively, if the transferee partner's outside basis was stepped-*down* under § 1014, the entity will reduce its inside basis by the excess of the transferee partner's share of inside basis over his or her outside basis. This adjustment to inside basis affects not just the allocation of gain and loss to the transferee partner upon a disposition of an FLP asset. It determines the partner's share of inside basis for purposes of depreciation deductions and distributions, as well.

[30] Treas. Reg. § 1.706-1(c)(2)(ii).

Here again, zealous preoccupation with valuation discounts can have an adverse income tax result (though usually not to such an extent that the valuation discounts have no net value).

EXAMPLE (10): Mom dies holding a 5% general partner interest and a 20% limited partner interest in FLP. FLP's assets have a combined liquidation value of $1,000,000 and an aggregate inside basis of $200,000. Mom's estate values the 5% general partner interest at $40,000 (assuming a 20% blended valuation discount against the $50,000 liquidation value attributable to the general partner interest) and it values the 20% limited partner interest at $120,000 (assuming a 40% blended valuation discount against the $200,000 liquidation value attributable to the limited partner interest). Both interests pass to Son. Son's aggregate outside basis is $160,000, the sum of the date-of-death values of the general and limited partner interests included in Mom's estate. If FLP has a valid § 754 election in effect, the $50,000 of aggregate inside basis (that portion of the inside basis attributable to Mom's interests) is increased to $160,000, *not* to its $250,000 liquidation value. Thus, while the § 754 election eliminates the disparity between inside and outside bases with respect to Son, the election does not completely eliminate the inherent gain attributable to the interests now held by Son; if FLP sells all of its assets, $90,000 of gain will be allocable to Son. Of course, this beats the $200,000 gain that would have been allocable to Son had no § 754 election been made. And the estate tax savings from an aggregate $90,000 discount likely exceeds the income tax burden from $90,000 of extra gain. But it shows that the higher the discount, the less beneficial the § 754 election becomes to the decedent's successor in interest.

Note that if the deceased partner's surviving spouse is also a partner in the FLP, and if the spouses owned their interests as community property, the surviving spouse's interest in the FLP also triggers an adjustment to inside basis if a § 754 election is in effect.

III. LIQUIDATION OF THE FLP

Like any partnership, the owners of interests in an FLP have two basic options for unwinding or dissolving the entity: sell the entity's assets and distribute the cash remaining after payment of debts to the partners, or distribute the entity's assets in kind to the partners.

Why would the partners seek to dissolve the FLP? Dissolution is common where the partnership assets are under-performing, and it also tends to occur shortly following the death of the surviving founder. Moreover, the recent permanent increase in the "applicable exclusion amount" for federal estate tax purposes to $5 million (as adjusted for inflation)[31] may undermine some of the transfer tax savings from the use of FLPs, and that may prompt the early liquidation of some entities. Yet no matter whether the founding partners are alive, income tax traps are ready to spring if liquidation occurs within seven years of the founding partners' contributions to the entity.

A. Asset Sale and Final Distributions

[31] I.R.C. § 2010(c). The $5 million applicable exclusion amount is effective for decedents dying in 2010 and 2011. The amount is adjusted for inflation as of 2012. In 2015, the "basic exclusion amount" was $5,430,000.

Section 704(c) requires any gain from the sale of appreciated property contributed to a partnership to be allocated among the partners in a manner that takes into account the property's built-in gain at contribution. Generally, such built-in gain must be allocated to the contributing partner;[32] any gain in excess of the built-in gain (attributable to post-contribution appreciation) may be allocated as the partners agree.[33] Those who succeed to all or a portion of a contributing partner's partnership interest inherit that share of the built-in gain attributable to the interest received.[34]

Following recognition and pass-through of gains and losses from the sale of the FLP's assets, a distribution of the remaining cash proceeds to the partners is taxable only to the extent that the distributed cash exceeds a partner's outside basis (the partner's basis in his or her partnership interest).[35]

B. In-Kind Distributions to Partners

In lieu of a sale of the FLP's assets, the partners might decide to dissolve the entity by distributing the assets to the partners. In this regard, the owners again have two options: proportionate (or "*pro rata*") distributions of each asset, wherein each partner receives a share of every asset according to the partner's interest in the FLP, or disproportionate ("cherry-picking") distributions of the assets, where entire assets are distributed to one partner to the extent possible.

> EXAMPLE (11): At the time of liquidation, FLP owns two assets: Blackacre, a parcel of investment property worth $600,000, and $400,000 in marketable securities. There are two partners in FLP: Dad, with a 5% general partner interest and a 35% limited partner interest, and Son, with a 60% limited partner interest. If Dad, as general partner, opts for a proportionate distribution of the assets, Dad will receive a 40% interest in Blackacre and a 40% interest in the marketable securities, while Son will receive a 60% interest in both assets. If Dad opts for disproportionate distributions, Dad could receive all of the marketable securities while Son takes all of Blackacre.

Depending on this choice and upon the composition of the FLP's assets, up to three Code provisions can come into play upon an in-kind distribution to a partner.

1. Section 704(c)(1)(B) Built-in Gain

[32] Treas. Reg. § 1.704-3. If the built-in gain has already been accounted for through the use of "remedial allocations," there is no need to allocate the built-in gain a second time to the contributing partner.

[33] In most cases, FLP agreements provide that any gain in excess of the § 704(c) built-in gain must be allocated to the partners in proportion to their partnership interests. This allows the partnership interests to avoid the "zero-value" rule of § 2701.

[34] Treas. Reg. § 1.704-3(a)(7).

[35] I.R.C. § 731.

Section 704(c)(1)(B) provides that if property distributed to one partner was contributed to the FLP by another partner within seven years of the distribution, and if that property had built-in gain at the time of contribution, then the contributing partner must recognize the built-in gain at the time of the distribution.

> EXAMPLE (12): In Year One, Dad and Daughter formed FLP when Dad contributed farmland worth $500,000 and with an adjusted basis of $300,000 in exchange for a 5% general partner interest and a 45% limited partner interest, and Daughter contributed cash in the amount of $500,000 for a 50% limited partner interest. In Year Five, FLP distributed the farmland to Daughter. Assuming the value of the land has not changed since contribution, Dad must recognize his $200,000 built-in gain from the farmland in Year Five.

Recognition of the built-in gain is avoided if the property is distributed back to the contributing partner. For this purpose, any assignee or successor to the contributing partner's interest is treated as the contributing partner to the extent of the built-in gain allocable to the assignee-successor's interest.[36]

> EXAMPLE (13): Assume the same basic facts from Example (12), except that in Year Four, Dad gave his general and limited partner interest to Son. In Year Five, FLP distributed the farmland to Son. Neither Dad nor Son recognizes gain from this distribution under § 704(c)(1)(B) since Son was Dad's successor in interest.

Recognition of the built-in gain is also avoided where all partners have § 704(c) built-in gain in proportion to their partnership interests and the partners effect a proportionate distribution of the entity's assets.[37]

> EXAMPLE (14): In Year One, Mom and Dad formed FLP by contributing farmland worth $1 million. Their basis in the contributed property was $200,000. In Year Five, Mom and Dad gave all of their interests in FLP in equal shares to Son and Daughter. In Year Six, FLP distributed the farmland in equal shares to Son and Daughter in liquidation of their interests in FLP. Because Son and Daughter are treated as the contributors of the farm under the successor-in-interest rule, and because the property is distributed to the partners in proportion to their shares of the built-in gain, § 704(c)(1)(B) does not apply.

But what if not every partner has a proportionate amount of § 704(c) gain and it is not possible (or desirable) to transfer the built-in gain property back to the contributing partner or his or her successor in interest? The easy solution is to wait seven years before making any distributions of contributed property that carry § 704(c) gain. Alternatively, consider a sale of the contributing partner's partnership interest to remove the § 704(c) taint altogether.[38] It should be kept in mind, too, that a § 754 election

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[36] Treas. Reg. § 1.704-4(d)(2).

[37] Treas. Reg. § 1.704-4(c)(6).

[38] Because a sale of a partnership interest would trigger tax for the contributing partner, any such sale should be structured as an installment sale to defer the reporting of gain.

might reduce the sting of § 704(c)(1)(B) to some extent, if the successor in interest is lucky enough to acquire the partnership interest by bequest.

2. Section 737 Gain Recognition to Contributing Partner

Section 737 generally provides that if a partner contributes appreciated property to the FLP and, within seven years of such contribution, receives a distribution of non-cash property, the contributing partner must recognize the § 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).

> EXAMPLE (15): In Year One, Dad and Daughter formed FLP when Dad contributed farmland worth $500,000 and with an adjusted basis of $300,000 in exchange for a 5% general partner interest and a 45% limited partner interest, and Daughter contributed cash in the amount of $500,000 for a 50% limited partner interest. FLP used the cash to acquire a small parcel of vacant land in the suburbs. In Year Five, FLP distributed the suburban land to Dad. Assuming the value of the contributed properties has not changed since contribution, Dad must recognize his $200,000 built-in gain from the farmland in Year Five.

As was the case with § 704(c)(1)(B), an assignee-successor to a contributing partner's interest is treated as a contributing partner for purposes of § 737's general rule.[39]

> EXAMPLE (16): Assume the same facts as the preceding example, except that in Year Four, Dad gifted his general and limited partner interests to Son. In Year Five, FLP distributed the suburban land to Son. Assuming the value of the contributed properties has not changed since contribution, Son "steps into Dad's shoes" and must recognize in Year Five the $200,000 built-in gain from Dad's contribution of the farmland in Year One.

On its face, § 737 would apply if the contributing partner received back from the FLP the appreciated property originally contributed to the partnership. Regulations recognize that because such a "return-to-sender" distribution is not taxable under § 704(c)(1)(B), § 737 does not apply if the contributing partner receives the property he or she originally contributed to the FLP.[40] Oddly, however, there is no rule providing that an assignee-successor to the contributing partner's interest likewise qualifies for this exception. It is therefore possible that an assignee-successor must recognize gain under § 737 upon receipt of property originally contributed to the FLP by the assignee-successor's predecessor in interest—even though the receipt of the contributed property by the same party is expressly *not* subject to § 704(c)(1)(B).[41]

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[39] Treas. Reg. § 1.737-1(c)(2)(iii).

[40] Treas. Reg. § 1.737-2(d)(1).

[41] For a contrary view, *see* Ellen K. Harrison and Brian M. Blum, *Another View: Responding to Richard Robinson's 'Don't Nothing Last Forever'—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 313, 315 (2003).

The moral of the story here is to postpone any distributions of § 704(c) property until the partnership has held such property for seven years, as § 737 only applies to distributions made within seven years of contribution.

3. Section 731(c) Treatment of Marketable Securities as Cash

Section 731(a)(1) provides that no gain is generally recognized upon a distribution from a partnership except to the extent that any cash received in the distribution exceeds the recipient partner's outside basis immediately prior to the distribution. For purposes of this rule, however, § 731(c) provides that marketable securities are treated as cash (valued at fair market value as of the date of distribution).

> EXAMPLE (17): Mom and Son formed FLP when Mom contributed a collectible with a value of $100,000 and a basis of $20,000 and Son contributed $100,000 cash. FLP used $50,000 of the cash to purchase Microsoft stock. FLP then distributed the Microsoft stock to Mom. Under § 731(c), the stock distribution is treated as a cash distribution in the amount of $50,000, the value of the Microsoft shares distributed. Mom must recognize a gain of $30,000 because the amount of deemed cash distributed exceeds her $20,000 outside basis.

By its terms, § 731(c) does not apply if one of the following events is presented: (a) the marketable securities received by the partner were those contributed by the same partner; (b) subject to some limitations, the marketable securities distributed were acquired by the FLP in a nonrecognition transaction;[42] (c) the distributed securities were not marketable when first acquired by the FLP and did not become marketable for at least six months;[43] or (d) the FLP is an "investment partnership" and is making a distribution to an "eligible partner."

This last exception requires elaboration. An FLP will qualify as an investment partnership if it has never been engaged in a trade or business and 90% or more of its assets, measured by value, have always consisted of portfolio assets.[44] And an eligible partner is any partner that contributed nothing but such portfolio assets to the FLP.[45] Notice that if the partners of the FLP avoid § 721(b) gain at formation by using any of the three techniques listed in Part I(A)(2) of this outline, the FLP may well be an investment

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[42] Treas. Reg. § 1.731-2(d)(1)(ii). The total cash and marketable securities acquired by the FLP in the nonrecognition transaction must be less than 20% of the value of the assets transferred by the FLP in the transaction. Furthermore, the distribution of the marketable securities must be occurring within five years of the FLP's acquisition of the securities (or, if later, within five years of the date upon which the securities became marketable).

[43] Treas. Reg. § 1.731-2(d)(1)(iii). Also, the FLP must be distributing the securities within five years of the date upon which they became marketable. Moreover, the issuer of the securities must not have issued any marketable securities prior to the time the FLP first acquired the distributed securities. Isn't this fun?

[44] Treas. Reg. § 1.731-2(c)(3)(i).

[45] Treas. Reg. § 1.731-2(e)(2)(i).

partnership for purposes of § 731, and the partners will likely be eligible partners. But if the FLP avoids § 721(b) because 20% or more of its assets at formation do not consist of portfolio assets, as discussed in Part I(A)(1) of this outline, the FLP is likely not an investment partnership, meaning this last exception to § 731(c) cannot apply.

Now let's return to the first exception: marketable securities will not be treated as cash for purposes of § 731 if they are distributed to the same partner that contributed them to the FLP. This is consistent with the exceptions under §§ 704(c)(1)(B) and 737. But here, too, just like § 737, there is no rule extending the exception to a distribution of marketable securities to an assignee-successor to the contributing partner's FLP interest.[46] In other words, those who receive a partnership interest by gift may have to recognize gain upon a distribution of marketable securities from the FLP even if those securities were contributed to the FLP by the donor. And the application of this rule does not expire after seven years.

EXAMPLE (18): Mom and Dad formed FLP by a contribution of many assets, including stock in Amazon.com. Mom and Dad gave a 10% limited partner interest to Daughter. Long after the gift, FLP distributed the Amazon.com stock to Daughter in liquidation of her interest. Daughter will be considered to have received a distribution of cash in an amount equal to the value of the Amazon.com stock pursuant to § 731(c) because none of the exceptions to § 731(c) apply.

As mentioned above, waiting seven years is not effective to avoid application of § 731(c). One solution is to effect a proportionate distribution of any marketable securities. By doing so, one makes better use of the limitation in § 731(c)(3)(B), which reduces the amount of the deemed cash distribution by the recipient partner's share of gain on the distributed securities.

EXAMPLE (19): In Year One, Mom, Son, and Daughter formed FLP. Mom contributed stock in Starbucks Corporation worth $900,000 (in which she had a basis of $720,000) to FLP in exchange for a 4% general partner interest and an 86% limited partner interest, while Son and Daughter contributed their undivided, one-half interests in a parcel of raw land worth a total of $100,000 (in which each child had a basis of $20,000) in exchange for a 10% limited partner interest (5% held by Son and 5% held by Daughter).

Mom died in Year Ten, leaving her general and limited partner interests in equal shares to Son and Daughter. At the date of Mom's death, the Starbucks stock is worth $1.5 million, and the raw land is worth $500,000. Mom's estate claims a 50% combined discount on the value of the FLP interests passing to Son and Daughter, reporting a combined value of $900,000 on Mom's federal estate tax return (90% interest in a total liquidation value of $2 million, less 50%). Each child's aggregate outside basis in FLP is now $470,000 ($450,000 attributable to the 90% interest from Mom that was stepped-

[46] Regulation § 1.731-2(d)(1) states, in relevant part that "section 731(c) and this section do not apply to the distribution of a marketable security if-(i) the security was contributed to the partnership by the distributee partner…." No mention is made of a successor in interest here.

up under § 1014 plus $20,000 attributable to the 10% interest acquired through their contribution).

If FLP distributes the Starbucks stock in equal shares to Son and Daughter, each child is deemed to receive a cash distribution of only $360,000 (not $750,000), because the $390,000 gain that would be allocated to each child from FLP's sale of the stock reduces the deemed cash distribution pursuant to § 731(c)(3)(B).[47] This deemed distribution is not taxable to either child because each has an outside basis in excess of the deemed distribution amount. The distribution will reduce each child's outside basis to $110,000 ($470,000 minus $360,000 deemed cash).[48]

If, instead, FLP distributes the raw land plus $500,000 of the Starbucks stock to Son ($1 million total) and the remaining $1 million of Starbucks stock to Daughter, the result changes. Daughter is deemed to receive a cash distribution of $610,000 (not $1 million), because the $390,000 gain that would be allocated to her from FLP's sale of the stock reduced the deemed cash distribution under § 731(c)(3)(B). Because Daughter's outside basis immediately prior to the distribution is $470,000, Daughter must recognize $140,000 of gain thanks to the deemed cash distribution. The disproportionate distribution of the Starbucks stock to Daughter in this case forced the recognition of gain that would not have occurred in a proportionate distribution of the stock.

Notice here that a § 754 election might be detrimental to the successors in interest. An increase in inside basis lessens the benefit of the § 731(c)(3)(B) reduction for the distributee's distributive share of gain on the property. If the FLP would realize no gain if it sold the distributed property, there is no reduction in the amount of the deemed cash distribution. Thus, while the § 754 election is generally beneficial in the context of §§ 704(c)(1)(B) and 737, it can be disadvantageous for purposes of § 731(c).

The § 731(c)(3)(B) gain limitation is handy where the FLP distributes marketable securities with a low inside basis. Partners should therefore be reluctant to distribute freshly-purchased marketable securities with an inside basis (nearly) equal to their value. Likewise, marketable securities that have recently declined in value are less attractive candidates for distribution to donee-partners.

While a proportionate distribution of marketable securities may be helpful in avoiding § 731(c), it presents problems outside of the tax realm. Beneficiaries are often reluctant to hold assets as tenants in common (proof that the minority interest discount and, to a greater extent, the marketability discount are quite real). If so, then perhaps the best solution to the § 731(c) problem lies back in the exceptions: where possible, the FLP should own only portfolio assets at all times and care should be taken to make sure each partner is an "eligible partner." Contributions of non-portfolio assets by children at formation of the FLP, sometimes used as a formation strategy in lieu of giving fractional interests in one or more of the contributed assets prior to formation, can be fatal in qualifying for the investment partnership exception since the children are not eligible partners.

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[47] For convenience, this Example assumes no § 754 election is in place.

[48] Note that § 704(c)(1)(B) does not apply in this Example because the distribution occurs after the seven-year period during which § 704(c)(1)(B) is alive.

One *bad* solution would be to reallocate the FLP's gain to the distribute partner in an effort to maximize use of the § 731(c)(3)(B) gain limitation. Regulations give the Service the power to disregard a blatant attempt to avoid § 731(c)(1) through a change in partnership allocations.[49]

4. Ordering Rules

Because one, two, or all three of the Code provisions described above may be triggered upon the liquidation of a family partnership, there must be some mechanism for sorting out how these provisions interact so that the same targets are not taxed twice. Regulation § 1.731-2(g)(1)(i) provides such an ordering rule. It says that one must *first* apply § 704(c)(1)(B), which, again, provides that a contributing partner recognizes the built-in gain or loss from contributed property if such property is distributed to another partner within seven years of the contribution. Remember that § 704(c)(1)(B) does not apply to the extent the contributed property is distributed back to the contributing partner or to the contributing partner's transferee.[50]

Second, one applies § 731(c), which treats a distribution of marketable securities to a partner as a distribution of cash. Accordingly, under § 731(a), the distribution will be taxable to the extent it exceeds the recipient partner's outside basis immediately prior to the distribution. Under § 731(c)(3)(B), the amount of the deemed cash distribution can be determined under the following formula:

	Fair market value of distributed securities
less	Distributee's share of net *gain* on sale of all similar partnership marketable securities
plus	Distributee's share of net *gain* on sale of *retained* similar partnership marketable securities
	Amount of deemed cash distribution

The effect of this formula is to tax the recipient partner on *all but* his or her share of the built-in gain attributable to the distributed securities. The gain portion will be taxed under § 737 in the next (and final) step.

Finally, one applies § 737, in which a contributing partner recognizes built-in gain (not loss) from contributed property if the contributing partner receives a non-cash asset in a distribution within seven years of the contribution. The amount of gain recognized by the contributing partner is the *lesser of* the following two amounts:

§ 737(a)(1) Amount: EXCESS DISTRIBUTION

	Fair market value of non-cash property distributed to contributing partner
less	Contributing partner's "reduced outside basis" (OB less cash in same distribution)
	"Excess distribution"

§ 737(a)(2) / § 737(b) Amount: NET PRECONTRIBUTION GAIN

Amount of § 704(c)(1)(B) gain allocable to contributing partner

[49] Treas. Reg. § 1.731-2(h)(1).

[50] Treas. Reg. § 1.704-4(d)(2).

if all § 704(c) assets were distributed to other partners

Two examples illustrate how this ordering rule operates in the typical family partnership setting.

EXAMPLE (20): Lear formed a limited liability company in Year One by transferring the following three assets in exchange for all of the voting and nonvoting interests in the entity:

Asset	Value	Adjusted Basis
Raw Land	$1,800,000	$1,200,000
Painting	$1,800,000	$1,500,000
Yacht	$2,400,000	$1,200,000

Over the course of Years One through Six, Lear effects gift transfers of LLC interests in equal shares to his three daughters, Regan, Goneril, and Cordelia. By the end of Lear's inter vivos giving, the daughters own all of the interests in the LLC (each has a one-third interest).

The daughters decided to liquidate the LLC in Year Seven. At the time of liquidation, the assets had the same values they had at the time of Lear's contribution in Year One. Regan received the raw land, Goneril received the painting, and Cordelia received the yacht. To calm the "tempest," Cordelia contributed $400,000 to the LLC immediately prior to liquidation, and the cash was split between Regan and Goneril. That way, everyone walked away with $2 million in goodies. At the time of liquidation, each daughter's outside basis was $1.3 million.

In this Example, § 731(c) does not apply because the LLC does not own any marketable securities. Thus, Example 20 illustrates only the application of §§ 704(c)(1)(B) and 737. The analysis is presented separately for each partner.

Example 20 Consequences to Regan: Section 704(c)(1)(B) applies to the painting distributed to Goneril and to the yacht distributed to Cordelia. From § 704(c)(1)(B)'s perspective, Regan (through her predecessor-in-interest, Lear) contributed a share of these assets to the partnership and watched the partnership distribute those interests to other partners within seven years of contribution. Section 704(c)(1)(B) does not apply to the raw land she receives because the return-to-sender exception that would apply to Lear if he got back the land he contributed applies to Regan as Lear's successor-in-interest. If the partnership sold the painting for its fair market value, the partnership would recognize a $300,000 gain (amount realized $1,800,000, less $1,500,000 inside basis). As a one-third partner (and a one-third successor to Lear's interest), Regan's share of that gain would be $100,000. Accordingly, Regan must recognize a $100,000 gain from the distribution of the painting to Goneril, although the character of that gain on these facts is likely long-term capital gain. With respect to the yacht, the partnership would recognize a $1.2 million gain if it were sold ($2.4 million amount realized, $1.2 million inside basis). Regan's share of that gain would be $400,000, so she must also recognize this gain from the distribution of the yacht to Cordelia. Thus, Regan recognizes a total $500,000 gain under § 704(c)(1)(B), $100,000 attributable to the painting and $400,000 attributable to the yacht.

It is important here to consider the effect of § 704(c)(1)(B) on Regan's outside basis. Specifically, Regan's outside basis is increased by the $500,000 gain recognized.[51] This brings her outside basis to $1.8 million.

Under § 737, Regan must recognize the lesser of the "excess distribution" amount and the "net precontribution gain." The excess distribution amount is determined by subtracting her "reduced outside basis" from the value of the property received in the distribution. Regan's reduced outside basis is her outside basis after the application of §§ 704(c)(1)(B) and 731(c), reduced by any cash received in the "same transaction." Here, the $200,000 cash payment from Cordelia is part of the same transaction as the land distribution to Regan, so Regan's reduced outside basis would be $1.6 million (the $1.8 million outside basis computed in the preceding paragraph less $200,000). The land, worth $1.8 million, exceeds this reduced outside basis by $200,000, and thus the excess distribution amount is $200,000.

The "net precontribution gain" amount is simply Regan's share of the gain to the partnership had it sold the land instead of distributing it to her. Had the partnership sold the land, its gain would have been $600,000 ($1.8 million amount realized, $1.2 million inside basis), and Regan's share of that gain would have been $200,000. The net precontribution gain amount thus equals the excess distribution amount, meaning Regan must recognize $200,000 gain under § 737. Had the property been distributed to the original contributing partner, Lear, § 737 would not apply at all because of the return-to-sender exception. There is no express authority that would permit Regan to claim this exception as Lear's successor, although some commentators take the position that Regan can (or at least should be able to) claim this exception.

The Example 20 analysis for Regan is summarized in Fig. 1.

FIG. 1 – EXAMPLE 20 TAX CONSEQUENCES TO REGAN

(1) § 704(c)(1)(B):

* Painting (distributed to Goneril) →	if the partnership sold the asset for FMV, there would be $300,000 of gain to the partnership. Regan's share of that gain would be **$100,000**.
* Yacht (distributed to Cordelia) →	if the partnership sold the asset for FMV, there would be $1,200,000 of gain to the partnership. Regan's share of that gain would be **$400,000**.

*Therefore, Regan recognizes a total **$500,000 gain** under § 704(c)(1)(B).*

(2) § 731(c): → does not apply because no marketable securities

(3) § 737: * Raw Land (received by Regan)

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	1,800,000	If the partnership sold the asset for FMV
- reduced OB	(1,600,000)	there would be $600,000 of gain to the
ED	***200,000***	partnership, ***$200,000*** allocable to Regan

*Therefore, Regan likely recognizes a total **$200,000 gain** under § 737.*

[51] Treas. Reg. § 1.704-4(e)(1).

As far as Regan is concerned, this is a fair result. Under § 732(b), Regan's basis in the raw land will be $1.8 million. Specifically, Regan's basis in the land is her outside basis immediately prior to the distribution ($1.3 million) plus the gain recognized under § 704(c)(1)(B) ($500,000), plus her gain recognized under § 737 ($200,000), less the cash received in the same transaction ($200,000).[52] If she sells the raw land the next day for its fair market value, $1.8 million, she will recognize no further gain or loss. This is fitting since she has already recognized the difference between the $2 million received in the liquidation ($1,800,000 of land plus $200,000 cash) and her pre-liquidation outside basis ($1.3 million).

Example 20 Consequences to Goneril: Fortunately, the results for Goneril are similar to those for Regan. Section 704(c)(1)(B) applies to the raw land distributed to Regan and to the yacht distributed to Cordelia. Section 704(c)(1)(B) does not apply to the painting she receives because the return-to-sender exception that would protect Lear from taxation if he received the painting in a distribution applies to Goneril as Lear's successor-in-interest. If the partnership sold the raw land for its fair market value, the partnership would recognize a $600,000 gain (amount realized $1.8 million, less $1.2 million inside basis). Goneril's share of that gain would be $200,000. Accordingly, Goneril recognizes a $200,000 gain from the distribution of the raw land to Regan. With respect to the yacht, the partnership would recognize a $1.2 million gain if it were sold (as shown in the analysis for Regan). Goneril's share of that gain would be $400,000, and this amount too is recognized. Thus, Goneril recognizes a total $600,000 gain under § 704(c)(1)(B), $200,000 attributable to the raw land and $400,000 attributable to the yacht. This would increase Goneril's outside basis to $1.9 million ($1.3 million plus the $600,000 of gain recognized under § 704(c)(1)(B)).

Under § 737, Goneril must compare the "excess distribution" amount and the "net precontribution gain." The excess distribution amount in turn requires a determination of Goneril's "reduced outside basis," meaning her outside basis after the application of §§ 704(c)(1)(B) and 731(c), reduced by any cash received in the same transaction. Again, the $200,000 cash payment from Cordelia is part of the same transaction as the distribution of the painting to Goneril, so Goneril's reduced outside basis would be $1.7 million (the $1.9 million outside basis computed in the preceding paragraph less $200,000). The painting, worth $1.8 million, exceeds this reduced outside basis by $100,000, so the excess distribution amount is $100,000. The "net precontribution gain" amount is likewise $100,000, for that would be Goneril's share of the gain to the partnership had it sold the painting instead of distributing it to her. Had the partnership sold the painting, its gain would have been $300,000 (as computed in the analysis for Regan), and Goneril's share of that gain would have been $100,000. Goneril must therefore recognize $100,000 of gain under § 737. Had the property been distributed to the original contributing partner, Lear, § 737 would not apply at all because of the return-to-sender exception. There is no express authority that would permit Goneril to claim this exception as Lear's successor; again, however, some commentators take the position that she can (or at least should be able to) claim this exception.

Fig. 2 (on the next page) summarizes the analysis for Goneril.

[52] Treas. Reg. §§ 1.704-4(e)(1); 1.737-3(b)(1).

FIG. 2 – EXAMPLE 20 TAX CONSEQUENCES TO GONERIL

(1) § 704(c)(1)(B):

* Raw Land (distributed to Regan) → if the partnership sold the asset for FMV, there would be $600,000 of gain to the partnership.

Goneril's share of that gain would be **$200,000**.

* Yacht (distributed to Cordelia) → if the partnership sold the asset for FMV, there would be $1,200,000 of gain to the partnership.

Goneril's share of that gain would be **$400,000**.

*Therefore, Goneril recognizes a total **$600,000 gain** under § 704(c)(1)(B).*

(2) § 731(c): → does not apply because no marketable securities

(3) § 737: * Painting (received by Goneril)

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	1,800,000	If the partnership sold the asset for FMV
- reduced OB	(1,700,000)	there would be $300,000 of gain to the
ED	***100,000***	partnership, ***$100,000*** allocable to Goneril

*Therefore, Goneril likely recognizes a total **$100,000 gain** under § 737.*

Here, too, this is a fair result. Under § 732(b), Goneril's basis in the painting will be $1.8 million. Specifically, her basis in the painting is her outside basis immediately prior to the distribution ($1.3 million) plus the gain recognized under § 704(c)(1)(B) ($600,000), plus her gain recognized under § 737 ($100,000), less the cash received in the same transaction ($200,000).[53] If she sells the painting the next day for its fair market value, $1.8 million, she will recognize no further gain or loss, again because the $700,000 difference between the $2 million Goneril receives in the liquidation ($1.8 million of painting plus $200,000 in cash) and her $1.3 million pre-liquidation outside basis is recognized upon liquidation.

Example 20 Consequences to Cordelia: Even less explanation is needed for Cordelia. Section 704(c)(1)(B) will apply to the raw land distributed to Regan (like Goneril, Cordelia will have to recognize $200,000 of gain) and to the painting distributed to Goneril (where, like Regan, Cordelia will recognize $100,000 of gain). Cordelia's total gain under § 704(c)(1)(B) is $300,000. This gain will increase her outside basis from $1.3 million to $1.6 million.

[53] Treas. Reg. §§ 1.704-4(e)(1); 1.737-3(b)(1).

Under § 737, Cordelia must compare the "excess distribution" amount and the "net precontribution gain." The excess distribution amount requires a determination of Goneril's "reduced outside basis," meaning her outside basis after the application of §§ 704(c)(1)(B) and 731(c), reduced by any cash received in the same transaction. Here, the $400,000 cash *paid* by Cordelia should be considered as part of her outside basis under § 722. Cordelia receives no cash in the liquidation, so her "reduced outside basis" really is not reduced at all—it's $2 million (the $1.6 million outside basis computed in the preceding paragraph plus $400,000). The painting, worth $2.4 million, exceeds this reduced outside basis by $400,000, so the excess distribution amount is $400,000. The "net precontribution gain" amount is also $400,000, for that is Cordelia's share of the $1.2 million gain to the partnership had it sold the yacht instead of distributing it to her. Cordelia will therefore recognize $400,000 of gain upon receipt of the yacht. Had the yacht been distributed to the original contributing partner, Lear, § 737 would not apply at all because of the return-to-sender exception. Once again, there is no express authority that would permit Cordelia to claim this exception as Lear's successor, although some commentators take the position that she can (or at least should be able to) claim it.

Fig. 3 summarizes the results for Cordelia under Example 20.

FIG. 3 – EXAMPLE 20 TAX CONSEQUENCES TO CORDELIA

(1) § 704(c)(1)(B):

* Raw Land (distributed to Regan) →	if the partnership sold the asset for FMV, there would be $600,000 of gain to the partnership. Cordelia's share of that gain would be **$200,000**.
* Painting (distributed to Goneril) →	if the partnership sold the asset for FMV, there would be $300,000 of gain to the partnership. Cordelia's share of that gain would be **$100,000**.

Therefore, Cordelia recognizes a total ***$300,000 gain*** *under § 704(c)(1)(B).*

(2) § 731(c): → does not apply because no marketable securities

(3) § 737: * Yacht (received by Cordelia)

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	2,400,000	If the partnership sold the asset for FMV
- reduced OB	(2,000,000)	there would be $1,200,000 of gain to the
ED	***400,000***	partnership, ***$400,000*** allocable to Cordelia

Therefore, Cordelia recognizes a total ***$400,000 gain*** *under § 737.*

Under § 732(b), Cordelia's basis in the yacht is $2.4 million, her outside basis immediately prior to the distribution ($1.3 million) plus the gain recognized under § 704(c)(1)(B) ($300,000), plus her gain recognized under § 737 ($400,000), plus the cash paid to the other partners as part of acquiring the asset

($400,000). If she sells the yacht the next day for its fair market value, $2.4 million, she will recognize no further gain or loss. Again, this is correct because §§ 704(c)(1)(B) and 737 force Cordelia to recognize the entire $700,000 difference between the amount Cordelia received in the liquidation ($2,400,000 of yacht) and her cost to acquire the property (her pre-liquidation outside basis of $1.3 million and her $400,000 of cash).

Example 21 illustrates the impact of adding § 731(c) to the mix by introducing marketable securities into the picture. It also illustrates how the distribution of loss property can wreak havoc on the recipient partner, probably unintentionally.

EXAMPLE (21): Lear formed a limited liability company in Year One by transferring the following three assets in exchange for all of the voting and nonvoting interests in the entity:

Asset	Value	Adjusted Basis
Microsoft Stock	$1,500,000	$ 300,000
United Airlines Stock	$1,500,000	$2,100,000
Raw Land	$1,500,000	$ 600,000

Over the course of Years One through Six, Lear effects gift transfers of LLC interests in equal shares to his three daughters, Regan, Goneril, and Cordelia. By the end of Lear's inter vivos giving, the daughters own all of the interests in the LLC (each has a one-third interest).

The daughters decided to liquidate the LLC in Year Seven. At the time of liquidation, the assets have the same values they had at the time of Lear's contribution in Year One. Regan receives the Microsoft shares, Goneril receives the United Airlines shares, and Cordelia receives the land.

What are the federal income tax consequences of the liquidating distributions, assuming each daughter's outside basis immediately prior to the liquidation was $1 million?

As with Example 20, the analysis here will be presented for each partner.

Example 21 Consequences to Regan: Section 704(c)(1)(B) will apply to the distributions of the United stock to Goneril and the raw land to Cordelia. Because the return-to-sender exception applies to Regan as Lear's successor in interest, § 704(c)(1)(B) has no effect on Regan's receipt of the Microsoft stock. The analysis here is similar to the analysis for Example 20: Regan must recognize her share of the partnership's gain upon a hypothetical sale of the raw land (her share of the $900,000 gain would be $300,000) and her share of the partnership's loss upon a hypothetical sale of the United stock (her share of the $600,000 loss would be $200,000). Combined, the gain and the loss change Regan's outside basis to $1.1 million ($1 million plus $300,000 gain minus $200,000 loss).[54]

[54] Treas. Reg. § 1.731-2(g)(1)(ii).

Under § 731(c), Regan must treat the non-gain portion of the Microsoft stock as a deemed cash distribution from the partnership. According to § 731(c)(3)(B), the non-gain portion is the excess of the stock's value ($1.5 million) over Regan's share of the gain if the partnership had sold the stock instead of distributing it in liquidation. This adjustment is required because § 737 will tax Regan on her share of this hypothetical gain (unless those commentators who insist that the return-to-sender exception applies to transferees are correct). If the partnership sold the Microsoft stock for fair market value, it would realize a $1.2 million gain ($1.5 million amount realized, $300,000 basis), and Regan's one-third share of that gain would be $400,000. Thus, the deemed cash distribution amount to Regan is $1.1 million ($1.5 million less $400,000). Since the amount of the deemed cash distribution exactly equals Regan's outside basis as adjusted for the gain and loss under § 704(c)(1)(B), she recognizes no gain from this deemed cash distribution, although her outside basis is reduced to zero.[55]

Finally, § 737 applies to the $400,000 gain portion of the Microsoft stock that was not treated as deemed cash for purposes of § 731(c).[56] Because her outside basis was reduced to zero through the combined operation of §§ 704(c)(1)(B) and 731(c), the excess distribution amount for § 737 purposes is the full $400,000. Not surprisingly, this is also the amount of net precontribution gain, for the $400,000 at play here represents pure gain, all of which is attributable to Regan. Consequently, Regan recognizes $400,000 of gain under § 737. The results for Regan under Example 21 are summarized in Fig. 4.

[55] Treas. Reg. § 1.737-1(b)(3)(i).

[56] Treas. Reg. § 1.731-2(g)(1)(iii)(A).

FIG. 4 – EXAMPLE 21 TAX CONSEQUENCES TO REGAN

(1) § 704(c)(1)(B):

* United (distributed to Goneril) → if the partnership sold the asset for FMV, there would be $600,000 of loss to the partnership.
* Regan's share of that loss would be **($200,000)**.

* Land (distributed to Cordelia) → if the partnership sold the asset for FMV, there would be $900,000 of gain to the partnership.
* Regan's share of that gain would be **$300,000**.

Therefore, Regan recognizes **($200,000) of loss** and **$300,000 of gain** under § 704(c)(1)(B).

(2) § 731(c): → Microsoft shares

Fair Market Value:	$1,500,000	
less Share of Net Gain:	(400,000)	← if partnership sold for FMV, her
Deemed Cash Distribution:	***$1,100,000***	share of the $1,200,000 gain

Beginning Outside Basis:	1,000,000		
704(c)(1)(B) Gain:	300,000		
704(c)(1)(B) Loss:	(200,000)		
Pre-Cash Outside Basis:		1,100,000	[see Reg. § 1.731-2(g)(1)(ii)]
731(c) Cash		***(1,100,000)***	
Remaining Outside Basis:		0	

So Regan recognizes **no gain** under § 731(c).

(3) § 737: → applies to the $400,000 portion of the Microsoft shares that was not treated as cash [Reg. § 1.731-2(g)(1)(iii)(A)]

* Microsoft (received by Regan)

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	400,000	If the partnership sold the asset for FMV
- reduced OB	(0)	there would be $1,200,000 of gain to the
ED	***400,000***	partnership, ***$400,000*** allocable to Regan

Therefore, Regan recognizes a total **$400,000 gain** under § 737.

Under § 732(b), Regan's basis in the Microsoft stock will be $1.5 million (her $1 million outside basis, increased by the $100,000 net gain under § 704(c)(1)(B) and the $400,000 gain under § 737). If she sells the stock the next day for its fair market value, also $1.5 million, she will recognize no further gain or loss. In summary, then, the $500,000 difference between the amount Regan receives in the liquidation ($1.5 million in stock) and her pre-liquidation outside basis ($1 million) is recognized entirely upon receipt of the shares. Importantly, however, that net gain comes in the form of $700,000 of gain and $200,000 of loss, and these two items may not perfectly offset for federal income tax purposes.

Example 21 Consequences to Goneril: Though some have little sympathy for Shakespeare's Goneril, this Example's Goneril is a tragic figure. Like Regan, Goneril will recognize a $300,000 gain from the distribution of the land to Cordelia under § 704(c)(1)(B). Section 704(c)(1)(B) also requires Goneril to recognize a $400,000 gain from Regan's receipt of the Microsoft shares, for a sale by the partnership of the Microsoft stock would trigger a $1.2 million gain, and $400,000 of that gain would be allocable to

Goneril. Altogether, Goneril recognizes $700,000 of gain under § 704(c)(1)(B). This substantial gain will be added to Goneril's outside basis, raising it to $1.7 million.

Section 731(c) will treat Goneril's receipt of the $1.5 million in United stock as the receipt of cash. Because the United stock is loss property, there is no "gain portion" to carve out from the value of the shares. Accordingly, the full $1.5 million in value will be treated as cash. While a $1.5 million deemed cash distribution would normally cause the oxygen masks to release from their overhead compartments, Goneril suffers no loss of cabin pressure here because her outside basis had swollen to $1.7 million thanks to the $700,000 gain from the application of § 704(c)(1)(B). In fact, the deemed cash distribution leaves Goneril with $200,000 of outside basis.

Section 737 does not apply to Goneril at all because the entirety of the United stock was treated as a deemed cash distribution under § 731(c).[57] This makes sense because there is no "net precontribution gain" on this loss property, meaning the "lesser of" amount for purposes of § 737(a) would necessarily be zero. But Goneril is left with $200,000 of unused outside basis. One might think that Goneril could deduct this amount as a loss under § 731(a)(2) because Goneril received a deemed distribution of cash from the partnership in liquidation of her interest. Unfortunately, such is not the case. Section 731(c)(1) expressly provides that Goneril's receipt of the United stock is treated as cash *only* for purposes of §§ 731(a)(1) and 737. Goneril's stock is not treated as cash for purposes of § 731(a)(2), so she cannot claim the loss.

The loss will be preserved in her basis in the United shares. Under § 732(b), Goneril's basis in the United stock will be $1.7 million (her $1 million original outside basis plus the $700,000 total gain under § 704(c)(1)(B)). If she later sells the stock for its fair market value at liquidation, $1.5 million, she can finally recognize the $200,000 loss. In effect, the $500,000 difference between the value of the United Stock and her pre-liquidation outside basis is accounted for in the harshest of ways: she must recognize $700,000 of gain first and then sell the distributed property to claim what hopefully proves to be an offsetting $200,000 loss. Congress gets more than the pound of flesh to which it is entitled.

The results for Goneril are summarized in Fig. 5 (on the next page).

[57] Treas. Reg. § 1.731-2(g)(1)(iii)(A).

FIG. 5 – EXAMPLE 21 TAX CONSEQUENCES TO GONERIL

<u>(1) § 704(c)(1)(B)</u>

* Microsoft (distributed to Regan) → if the partnership sold the asset for FMV, there would be $1,200,000 of gain to the partnership.

Goneril's share of that gain would be **<u>$400,000</u>**.

* Land (distributed to Cordelia) → if the partnership sold the asset for FMV, there would be $900,000 of gain to the partnership.

Goneril's share of that gain would be **<u>$300,000</u>**.

Therefore, Goneril recognizes **<u>$700,000 of gain</u>** under § 704(c)(1)(B).

<u>(2) § 731(c)</u>: → United shares

Fair Market Value:	$1,500,000	
less Share of Net Gain:	(0)	← if partnership sold for FMV,
Deemed Cash Distribution:	***$1,500,000***	there would be no gain!

Beginning Outside Basis:		1,000,000	
704(c)(1)(B) Gain:	700,000		
Pre-Cash Outside Basis:		1,700,000	[see Treas. Reg. § 1.731-2(g)(1)(ii)]
731(c) Cash		***(1,500,000)***	
Remaining Outside Basis:		200,000	

So Goneril recognizes **<u>no gain</u>** under § 731(c).

<u>(3) § 737</u>: → does not apply because the entire United distribution was treated as cash [Treas. Reg. § 1.731-2(g)(1)(iii)(A)]

The numbers prove this to be true anyway:

<u>737(a)(1) Excess Distribution</u>		<u>737(a)(2)/(b) Net Precontrib Gain</u>
FMV	0	If the partnership sold the asset for FMV
- reduced OB	(200,000)	there would be no gain to the partnership
ED	***0***	

Therefore, Goneril recognizes **<u>no gain</u>** under § 737.

<u>Example 21 Consequences to Cordelia</u>: The analysis here is not novel, for Cordelia is the only partner that does not receive marketable securities, rendering § 731(c) moot. Under § 704(c)(1)(B), Cordelia will recognize a $400,000 gain from the distribution of the Microsoft shares to Regan (just like Goneril), and Cordelia will recognize a $200,000 loss from the distribution of the United shares to Goneril (as was the case for Regan). The net $200,000 gain from application of § 704(c)(1)(B) will increase Cordelia's outside basis to $1.2 million.

Section 737 will tax Cordelia on her receipt of the land, again because the return-to-sender exception likely does not apply to Cordelia as Lear's successor in interest. The excess distribution amount is $300,000 ($1.5 million value of the land less Cordelia's $1.2 million outside basis), and that is also the amount of the net precontribution gain (if the partnership sold the land instead of distributing it, the partnership would realize a $900,000 gain, $300,000 of which would be allocated to Cordelia). Therefore, Regan recognizes a $300,000 gain under § 737.

These results are summarized in Fig. 6.

FIG. 6 – EXAMPLE 21 TAX CONSEQUENCES TO CORDELIA

(1) § 704(c)(1)(B):

* Microsoft (distributed to Regan) →	if the partnership sold the asset for FMV, there would be $1,200,000 of gain to the partnership. Cordelia's share of that gain would be **$400,000**.
* United (distributed to Goneril) →	if the partnership sold the asset for FMV, there would be $600,000 of loss to the partnership. Cordelia's share of that loss would be **($200,000)**.

Therefore, Cordelia recognizes **$400,000 of gain** and **($200,000) of loss** under § 704(c)(1)(B).

Beginning Outside Basis:	1,000,000	
704(c)(1)(B) Gain:	400,000	
704(c)(1)(B) Loss:	(200,000)	
Pre-Cash Outside Basis:	1,200,000	[see Treas. Reg. § 1.731-2(g)(1)(ii)]

(2) § 731(c): Does not apply because Cordelia received no marketable securities.

(3) § 737: → * Land (received by Cordelia)

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	1,500,000	If the partnership sold the asset for FMV
- reduced OB	(1,200,000)	there would be $900,000 of gain to the
ED	***300,000***	partnership, ***$300,000*** allocable to Cordelia

Therefore, Cordelia recognizes a total **$300,000 gain** under § 737.

Under § 732(b), Cordelia's basis in the land will be $1.5 million ($1 million outside basis plus the $200,000 net gain under § 704(c)(1)(B) plus the $300,000 gain under § 737). If she sells the land the next day for its fair market value, $1.5 million, she will recognize no further gain or loss. In summary, then, the $500,000 difference between the amount Cordelia receives in the liquidation ($1.5 million in land) and her pre-liquidation outside basis ($1 million) is recognized entirely upon receipt of the land.

5. Thoughts on the Ordering Rules

Although § 731(c) applied to the partners who received marketable securities in Example 21, neither partner recognized any gain because taxable distributions to other partners under § 704(c)(1)(B) increased outside basis to the point that the deemed cash distributions were not taxable. In what situations, then, would § 731(c) trigger a recognized gain for the partner receiving marketable securities from a liquidating family partnership? Three scenarios come readily to mind. First, if the partnership's other assets were loss properties, § 704(c)(1)(B) would reduce outside basis, increasing the risk of taxation from the receipt of deemed cash. Second, if the aggregate outside bases of the partners were substantially less than the aggregate inside bases of the partnership's assets, there is a much greater chance for a taxable deemed-cash distribution. This scenario can happen if the partners have not agreed to a § 754 election, for instance. Finally, and perhaps most likely, a deemed cash distribution would be taxable if the liquidation occurred more than seven years after the date when the partnership received its assets via contribution. At such time, § 704(c)(1)(B) would no longer apply, thus preventing a build-up of outside basis.

Where marketable securities are not involved, §§ 704(c)(1)(B) and 737 by themselves effectively transform the liquidation of a family partnership into a completely taxable event. Example 20 showed that the partners recognized all of their pre-liquidation gain at the time of liquidation, even though the general principle states that in-kind partnership liquidations are tax-free. The results in Example 20 should not be read to mean that all family partnership liquidation transactions will be completely taxable. Had there been a disparity between the aggregate inside bases and aggregate outside bases, for instance, the partners may well have been able to defer some portion of the pre-liquidation gain. But in the traditional family partnership setting, such a disparity is rare. In most cases, then, the moral of the story is to make sure seven years pass between the contribution of appreciated property to the family partnership and liquidating distributions to the founding partners' successors in interest.

IV. CONCLUSION

An FLP offers significant wealth transfer tax advantages. With proper planning throughout the life of the entity, an FLP can also maximize the advantages of pass-through taxation without significant risk of falling into the federal income tax traps applicable to all partnerships and those specifically designed for family partnerships.