BUSINESS SUCCESSION ISSUES INVOLVING SECOND AND THIRD GENERATIONS THAT HAVE NO DESIRE TO BE PARTNERS

I. INTRODUCTION

Peyton and Eli are brothers, and they are also partners in the HutHut, FLP (sometimes the "Partnership"). The Partnership is a limited partnership with a partnership agreement (sometimes the "Agreement") in place that consists of provisions normally found in such agreements. The brothers' parents, Archie and Olivia, have been financially successful and Peyton and Eli are partners as a result of estate planning strategies implemented by their parents. Archie and Olivia are also partners. A limited liability company owned by Archie and Olivia is the general partner. Peyton comes to you because his relationship with his brother has deteriorated. He's lived in the Midwest for many years and his brother has been in New York. They have very different lifestyles and these days they do not see eye to eye on many things. Peyton also watches his money closely and is tired of the annual expenses associated with the Partnership. Peyton is tired of dealing with the partnership and dealing with Eli. He wants you to help him negotiate a dissolution of the Partnership or, if that is not possible, his withdrawal from the Partnership. The purpose of this article is to discuss the various issues that Peyton and the other partners will face.

Due to the enactment on January 2, 2012 of the American Taxpayer Relief Act of 2012 ("ATRA"), the transfer tax landscape has dramatically changed, and, with those changes, we've seen families motivated to unwind prior planning because, in their minds, it creates more complexity than value. Additionally, we consistently see family members who are disenchanted with the idea of continuing business ventures with one another. This article lays out many of the issues present when second and third generation partners desire to dissolve a partnership, whether the motivation is for more simplicity or separation. The scenarios discussed generally involve second generation family members, however, the analysis will be applicable to third generation family members as well.

Years ago a wise man told me that it is significantly easier to create a partnership than break up one, and this article strongly supports that notion. Issues addressing existing contracts, creditors' claims, and the distribution of assets must all be confronted in a thoughtful and sound manner. The process must factor in the rights of each partner as well as third parties, such as creditors. There also are tax-traps and adverse non-tax consequences to avoid.

The keys to representing Peyton are fourfold: 1) comparing for him the benefits of remaining a partner versus withdrawing from or dissolving the Partnership; 2) advising him of the intra- family relational risks that might be created by going public with his desires; 3) informing him of the tax traps presented in a dissolution or withdrawal; and 4) if he decides to proceed with the dissolution goal, educating him on the dissolution process.

II. BENEFITS OF BEING A PARTNER.

Limited partnerships have been a very popular planning tool over the last several decades and for good reason. They offer very appealing benefits from a planner's perspective. Thus, before Peyton finalizes his decision on whether or not to seek a dissolution or withdrawal, it is important to remind him of the following benefits his family receives from the partnership.

A. Consolidated Control.

In advising Peyton, it is important to emphasize the differences in management and control of assets owned by individuals compared to those owned by partnerships. The limited partnership structure divides ownership of the partnership into limited and general partnership interests. Owners of the general partner interests are in control, and owners of limited partner interests are passive or have practically no decision-making authority. This bifurcation of the ownership interests is often a key element in family- owned partnerships, and encourages planning as it allows parents to gift significant family wealth to children and grandchildren—through the transfer of limited partner interests—without losing control over the underlying assets of the partnership. Parents can retain general partnership interests, in small percentages of the partnership, and retain control of the underlying assets of the partnership while gifting or selling significant wealth in the form of limited partner interests. Parents owning general partnership interests are able to:

- Manage the underlying assets;
- Decide when to sell partnership assets or purchase additional assets for the partnership; and

- Determine amounts and timing for cash distributions to the partners.

If HutHut, FLP is dissolved, the family will lose the division or branches of ownership interests and this result can curb Archie's and Olivia's willingness to carry out future estate planning. In other words, a dissolution may stall the migration of wealth to younger generation family members. Furthermore, Archie and Olivia will think twice before they consent to the dissolution since it will likely result in them losing control of the underlying assets.

B. Consolidation of Assets.

Another benefit of limited partnerships is the ability to consolidate fractional ownership interests in assets into a single ownership structure that allows for more efficient management. Specifically, the partnership structure can facilitate an equitable expense allocation among the partners, provide a clear exit strategy for a partner who wants out, and provide a way to consolidate or delegate management decisions.

A family may take advantage of these benefits when it owns a valuable asset such as a ranch. Family members may have pooled their assets together to purchase the ranch and transferred their interests to a partnership because they wanted to share expenses and they wanted clarity and direction for the management of the asset. Or possibly, a first generation family member initially individually purchased property and then transferred it to a partnership, which now has many partners through gifts of limited partner interests to second and third generation family members.

By consolidating fractional ownership interests, a partnership provides a valuable centralized structure with the capability of avoiding many of the complexities and disagreements that arise out of family members owning fractional interests.

C. Restrictions on Transfers.

As we well know, generally, the patriarch or matriarch of a family desires for family assets to stay within their family. However, the death, divorce or incapacity of a family member can lead to the ownership of family assets by non-family members. Typically partnership agreements restrict limited partners from transferring their limited partnership interest to prospective owners who are not in a defined class of transferees. These restrictions control upon the death, divorce or incapacity of a partner, instead of a partner's will, divorce decree or fiduciary. Thus, the partnership may not recognize transfers to individuals who are not partners or are not family members of a partner without the consent of all the partners.

Furthermore if a child inherits partnership interests as opposed to the underlying assets of a partnership, it is more difficult for such assets to become commingled in a marital estate and thus lose their separate property character. The commingling of cash between spouses is quite common, but the commingling of limited partnership interests is not.

The point is, if underlying assets of HutHut, FLP are eventually owned outright by Peyton, Eli, and/or their children, there is an increased possibility family assets could end up in the hands of an ex-spouse or a creditor or someone else outside the family. If the Partnership continues, the family will more likely succeed in passing family assets from one generation to the next.

D. Creditor Protection.

1. <u>Claims within a partnership</u>.

Due to their creditor protection qualities, many partnerships own residential and commercial rental properties and other types of liability-producing assets that can create creditor exposure. In Texas, a limited partnership protects its limited partners from personal liability for the partnership's debts, expenses, and obligations. In essence, a limited partner, individually, cannot be forced to pay off business debts or claims with personal assets; however, a limited partner can lose his financial investment in the partnership. On the other hand, general partners are personally liable for partnership liabilities which is why limited liability companies are often formed to own general partnership interests. Dissolving a partnership that owns a liability producing asset and distributing that asset in-kind to partners will dissolve the creditor protection afforded by the partnership and leave the partners personally exposed to the liabilities related to the distributed assets.

For Peyton, a possible response to this potential problem is for him to create an entity such as a limited liability company, that would hold any liability producing assets he might receive in the dissolution. As a result, Peyton would have to continue to deal with the management and maintenance of an entity, but on the bright side, he would not be partners with Eli anymore.

2. Claims outside the partnership.

Claims outside the partnership refer to those claims for which a partner is personally liable which are unrelated to the partnership. A creditor of a partner possessing a claim outside the partnership does not have the right to claim possession of, or exercise any remedies with respect to, the property owned by a limited partnership. In Texas, a creditor of a limited partner is limited to obtaining a charging order against the partner's partnership interest. A charging order will entitle the creditor to receive any distributions from the partnership that would otherwise be made to the partner. A charging order in many respects is considered a lien on the partner's interest.

Section 153.256 of the Texas Business Organizations Code ("BOC") sets forth the protection of assets owned by a partnership that otherwise would be subject to claims of an individual partner's creditors, if held in that partner's outright ownership. It provides that upon application of a judgment creditor, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. The Section goes on to provide that a judgment creditor has only the rights of an assignee of the partnership interest.

Furthermore, a creditor holding a charging order receives distributions but cannot vote or impact partnership decisions. The creditor does not receive any rights to interfere in the partnership's operations. Because the rights of a creditor are limited to a charging order, creditors are not attracted to limited partner interests as they pursue the satisfaction of their claim or judgment.

E. Valuation Discounts for Transfer Tax Planning.

The value of assets for transfer tax purposes is the fair market value of the assets on the date of transfer. For instance, real estate, securities, etc, transferred in whole to a child are valued at the fair market value of the asset. However, if such assets are held in a limited partnership, when an individual is given or is sold a limited partnership interest, the value of the limited partnership interest for transfer tax purposes is potentially entitled to valuation discounts due to lack of marketability and lack of control. Depending on the underlying assets, a limited partnership interest may be subject to a discount that is commonly between 20% to 40%. If a partnership is dissolved and the partners receive in-kind distributions of the partnership assets, the partners will lose the discounts for transfer tax planning. If a partner has a taxable estate, the decision to dissolve the entity or withdraw as a partner can result in significant transfer tax exposure that otherwise was avoidable.

Peyton has followed in his father's footsteps and has been very successful in his own career, having amassed wealth separate and unrelated to the partnership. Peyton's personal estate exceeds the exemption amounts for transfer taxes. Therefore, if the dissolution or withdrawal does occur, the advisor must make sure Peyton considers additional planning with the assets he receives in order to recapture the discount positions that are lost.

Furthermore, for moderately wealthy clients who are convinced they do not need transfer tax planning due to ATRA, the advisor should mention that even though there are no sunset provisions in ATRA pertaining to the transfer tax exemptions, there still is the possibility that tax laws can change resulting in lower exemptions in the future.

F. Reasons for Family Interactions.

In many situations, a family-owned partnership keeps a family united; it creates a reason to bring the members together. The business issues of the partnership can cause communications and a closeness among the members which would not otherwise occur. In Peyton's family, his brother and parents live in different states, and it is typical in this day and age to see a family dispersed across the country. Although Peyton's and Eli's relationship is strained, the Partnership has caused Peyton to strengthen his relationship with Archie and Olivia as they work through issues related to the Partnership.

G. Avoidance of Ancillary Probate.

Ancillary probate proceedings may be necessary for a Texas resident who dies owning real property outside of Texas. This is a proceeding in addition to a domiciliary probate proceeding and is one that is nice to avoid with proper planning. When a decedent owns property located in his state of residence, that state's courts can issue the necessary orders to distribute the property but cannot issue orders regarding real property located in other states. For example, if Peyton lives in Texas and owns a second home in Colorado, the laws of Colorado dictate what must be done in regards to transferring Peyton's Colorado real property.

One way to avoid an ancillary probate is to transfer out-of-state real property to an entity such as a limited partnership. Unlike real property interests outside of Texas, a Texas executor will have authority to address issues related to interests in a limited partnership which owns property in another state.

Therefore, Peyton's receipt of HutHut, FLP property in his individual capacity may create the need for an ancillary probate at his death. However, Peyton can avoid an ancillary probate by placing the out-of-state property in a living trust or an entity such as a limited liability company.

As Peyton considers his options, it is crucial for him to review the foregoing partnership benefits as there are many. Additionally, Peyton needs to be aware that it is likely all the partners will need to consent to a dissolution. Consent requirements are covered in more detail in Section IV of this article. Also, Peyton's desire to dissolve may affect his relationship with his parents, Archie and Olivia. It may upset them. Moreover, if his parents were the contributors of the Partnership assets, and Peyton is now complaining about how they have structured his benefit in such assets, Archie and Olivia may be less inclined to benefit him further with their other assets.

It is possible the benefits may dissuade the family from dissolving the Partnership; but if not, Peyton's analysis is not over as you still need to advise him on the income tax implications of a dissolution, which are covered in the next section.

III. INCOME TAX TRAPS TO WATCH FOR IN A DISSOLUTION OR WITHDRAWAL

As estate planners, we are most comfortable focusing on transfer taxes. However, for Peyton, the dissolution of the Partnership or his withdrawal from the Partnership will trigger income tax issues and could result in a recognized gain or loss. Often, an estate planning attorney's preference or habit when confronted with income tax matters is to refer the client to a trustworthy accountant. However, as you advise Peyton, it is crucial that you have a good understanding of the income tax issues involved. That said, early on in your representation of Peyton it would be wise to get the family's accountants involved.

A. General Rule.

The general rule, although wrought with exceptions, is that neither a partner nor the partnership recognizes gain or loss on a distribution of money or property to a partner. See Section 731 (a) and (b) of the Internal Revenue Code ("IRC"). However, several types of distributions from a partnership trigger gain, so advisors should learn to recognize them.

B. Sale of Partnership Assets to Distribute Cash.

As a part of a dissolution, instead of making in-kind distributions to partners, a partnership may choose to sell the partnership assets and distribute cash. Although using cash in liquidating distributions can make it easier to reach a fair and equitable result among the partners, negative tax results can arise when the partnership sells the assets. For instance, IRC Section 704(c)(1)(A) states:

> Income, gain, loss and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

Therefore, any gain from the sale of appreciated property of a partnership must be allocated among the partners in a manner that takes into account the property's built-in gain at the time the asset was contributed to the partnership.

For instance, if a partner contributes property (the "contributing partner") with a fair market value in excess of its adjusted basis (property with built-in gain), and the partnership subsequently sells the asset, the built-in gain must be allocated to the contributing partner. Further, any excess gain will be allocated pursuant to the partnership agreement. Most agreements allocate excess gain to the partners in proportion to their partnership interests. Also note that if the contributing partner assigns his interest, the assignee or recipient of his interest will assume the contributing partner's share of built-in gain.

For example, Peyton decides to contribute property located in Colorado to HutHut, FLP and at the time it is contributed, the property has an adjusted basis of $60,000 and a fair market value of $100,000. At the time the property is contributed, Archie and Olivia are no longer partners, having sold and gifted their interests to the brothers over the past several years. As a result of Peyton's contribution, he and Eli each own 50% of the Partnership. HutHut, FLP soon thereafter sells the property for $120,000 and recognizes a $60,000 gain. The Partnership then liquidates. How should the $60,000 gain be allocated? Answer: IRC Section 704(c) requires the first $40,000 gain to be allocated to the contributing partner, Peyton. The remaining gain of $20,000 is equally allocated to Eli and Peyton due to the terms of the Partnership Agreement.

Additionally, regarding a partner's basis in his partnership interest, often referred to as "outside basis," following the recognition and pass-through of gains and losses from the sale of the assets and required adjustments to a partner's outside basis, a distribution of cash is only taxable to the extent the distributed cash exceeds the partner's outside basis. IRC Section 731(a)(1). Furthermore, a partner's outside basis must be increased by the partner's share of partnership income and gain items and reduced by the partner's share of partnership losses and expenditures.

C. Using In-Kind Distributions.

Often, if not the majority of the time, partners going through a dissolution will have an emotional or sentimental attachment to specific partnership assets which will discourage the sale of assets in the dissolution process. A partnership might own a family farm or family business which has been in the family for decades. Maybe the partnership owns a classic car, piece of art, MVP trophies, or Super Bowl rings from which the family will not part under any condition. There may be tax-related reasons for the partnership to make in-kind distributions. There are two approaches for in-kind distributions: 1) each partner receives a share of every asset owned by the partnership proportional to his or her interest in the partnership; or 2) entire assets are distributed to one partner to the extent possible. With either approach, it can be challenging for the partnership to fairly treat each partner which can create a multitude of non-tax related issues. On top of that, most of the tax traps occur when a partnership distributes the underlying assets in a dissolution or a withdrawal of a partner as opposed to selling the assets and distributing cash.

1. IRC Section 704(c)(1)(B)

IRC Section 704(c) property is property that had a built-in gain or loss at the time it was contributed to a partnership. Sometimes distributions of IRC Section 704(c) property cause the contributing partner to recognize gain. Congress enacted Section 704(c)(1)(B) to deter the use of partnerships to effect tax-free exchanges of built-in gain. Accordingly, under IRC Section 704(c)(1)(B), if a partnership distributes Section 704(c) property to a partner other than the contributing partner, within seven years of such property being contributed, the contributing partner recognizes built-in gain or loss on the property at the time of the distribution. IRC Section 704(c) treats the distribution as if it were a sale taking place, and the sale is deemed to occur at the property's fair market value. The deemed sale requires the contributing partner to recognize any built-in gain that was inherent in the property at the time of its contribution to the partnership but not the post-contribution gain.

<u>Calculation of gain or loss</u>. If a deemed sale occurs, the contributing partner will recognize the lesser of:

- the built-in gain or loss inherent in the property at the time of contribution, or
- the gain or loss that would be allocated to the contributing partner if the partnership sold the property to the distributee for its fair market value.

Imagine that separate from HutHut, FLP, Peyton and Eli form an equal partnership, Omaha, FLP. Peyton contributes to the partnership two tracts of land, the "North Lot" and the "South Lot." Both lots have a basis of $40,000 and a fair market value of $100,000. Eli contributes $200,000 cash. So both lots are IRC Section 704(c) property because they each have a built-in gain which is $60,000. The partnership uses the cash to subdivide the lots. After four years when it is worth $150,000, Omaha, FLP distributes the North Lot to Eli. As a result, Peyton as the contributing partner must recognize the lesser of:

(a) $60,000, which was the property's built-in gain or loss at the time of contribution; or
(b) $85,000, the amount that Peyton would recognize had the partnership sold the property for its fair market value (built-in gain of $60,000 plus half of the $50,000 gain that accrued in the hands of the partnership).

Therefore Peyton would recognize a $60,000 gain upon the distribution.

In advising Peyton, make sure you confirm whether or not a partner has contributed property within the past seven years. If so, determine if the partner contributed Section 704(c) property. Additionally, if it appears Section 704(c) is a concern, make sure Peyton understands that recognition of gain or loss is avoided if the contributed property is distributed back to the contributing partner or the transferee partner. Also, recognition of gain or loss can also be avoided if the partnership can wait seven years after the contribution was made before making distributions of property with built-in gain.

The following are a couple of things to note before moving on:

- Recognition of gain or loss by the partner triggers adjustment to both the inside basis of the property and to the partner's outside basis immediately before the distribution.
- If the contributing partner assigns his interest in the partnership prior to the distribution, the transferee partner would receive or step into the contributing partner's shoes for purposes of Section 704(c)(1)(B).
- There is a "return to sender exception" applied to Section 704(c) property, meaning that the contributing partner avoids the recognition of built-in gain or loss if the distribution of the contributed property is made back to the contributing partner.

2. IRC Section 731(c).

Under IRC Section 731(c), all or some part of marketable securities may be treated the same as a cash distribution. Section 731(a)(1) generally provides that partners do not recognize gain on a cash distribution; however, a partner will recognize gain to the extent that cash distributed exceeds the adjusted basis in his interest in the partnership immediately prior to the distribution. In other words, to the extent the amount of marketable securities treated as cash exceeds a partner's basis in his partnership interest, the distribution is taxable. IRC Section 731(a). This rule applies to current distributions and distributions in liquidation of a partner's full interest.

Pursuant to Section 731(c)(2), marketable securities include stocks and other equity interests including common trust funds, regulated investment companies, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, derivatives, foreign currencies, precious metals, and interests in entities containing such property.

Assume that in connection with a liquidation of Peyton's interest in HutHut, FLP, the Partnership distributes $50,000 in cash and Treasury bills with a value of $100,000 to Peyton, who has a basis of $75,000 in his partnership interest. The Treasury bills held by the Partnership have a basis equal to their fair market value and the Partnership has no other appreciated marketable securities. The distribution of the Treasury bills is treated as a cash distribution with the result that Peyton recognizes $75,000 ($150,000-$75,000) of gain on the distribution.

Also be aware that the IRC allows a reduction in the amount of marketable securities treated like cash to the extent of a partner's own share of the unrealized gain in the securities he receives. Section 731(c)(3)(B). To calculate the reduction, the partner's share of net gain in the partnership's marketable securities is measured before and after the distribution. The value of the securities he receives that is treated like cash is reduced by an amount equal to the difference in the two measurements.

The formula to determine the amount of deemed cash is the following:

Fair Market Value of the Distributed Securities

MINUS

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

PLUS

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

EQUALS

Amount of Deemed Cash Distribution

Once you have the amount of deemed cash distribution, you can calculate the Section 731 gain to be attributable to such partner upon the distribution of marketable securities. However, if the formula has your head spinning, review the following example which can be found in Reg. 1.731-2(j) which I came across in Carol A. Cantrell's article "Compensation, Distributions, Withdrawals, and Other Income Tax Problems with Mature FLP" 27th ANNUAL ADVANCED ESTATE PLANNING AND PROBATE COURSE (June, 2003):

> Able and Baker form a partnership AB as equal partners. AB holds securities X, Y, and Z worth $100 each. The basis of these securities is $70, $80, and $110 respectively. In order to avoid recognizing a $30 gain on the sale of X, the partnership distributes it to Able. Able=s share of the gain before the distribution is $20 and his share of the gain after the distribution is $5. Thus, Able is allowed to reduce the portion of Security X that is treated like cash to him by the $15 difference. So, only $85 of Security X is treated like cash. The balance is treated like property.

WITH X:

Security	Value	Basis	Gain/Loss	Ables 50% Share
X	100	70	30	
Y	100	80	20	
Z	100	110	-10	
	300	260	40	$20

WITHOUT X:

Y	100	80	20	
Z	100	110	-10	
	200	190	10	5
				$15

There are four situations where Section 731(c) will not apply, or in other words, there are four exemptions from any portion of marketable securities being treated like cash. First, marketable securities are not treated as money when distributed to the partner who contributed the security. This is referred to as the "return to sender exception." For instance, in the previous example, if Peyton contributed the Treasury bills to the Partnership and later takes a distribution of the same Treasury bills, he does not treat any part of them like cash. However if Peyton gives his partnership interest to Eli, who takes a distribution of the Treasury bills, Eli is not treated as the contributing partner for this purpose. Therefore Eli treats the Treasury bills as cash subject to the rule that allows him to reduce the cash portion by his share of the appreciation. Second, marketable securities are not treated like money if the property was not a marketable security when acquired by the partnership. Third, securities acquired by the partnership in a non recognition transaction are not treated like money. Fourth, marketable securities are not treated like money when distributed by an "investment partnership" to an "eligible partner." Reg. 1.731-2(d). An investment partnership is a partnership which has never been engaged in a trade or business (other than investing) in substantially all of the assets of which have always consisted of investment type assets.

Note that according to Section 731(a), loss will only be recognized by a partner if 1) it stems from a liquidation of his entire partnership interest and 2) if the partner receives money, unrealized receivables, and/or inventory items (see definitions in 751(c) and 751(d)).

3. IRC Section 737.

In 1992, IRC Section 737(a) was enacted to supplement Section 704(c)(1)(B) to deter the use of partnerships to effect tax-free exchanges of built-in gain property. Under IRC Section 737, when a partner contributes appreciated property and within seven years receives a distribution of any other partnership property (other than money), gain, but not loss, may be recognized by the partner. In essence, Section 737 takes the position that the partner, by receiving other property, is effectively "selling" any appreciated property that was contributed during the previous seven years. Additionally, it should be noted that gain recognized under Section 737 is in addition to any gain recognized under Section 731. Therefore a distribution could result in gain recognized under both Section 731 and Section 737.

Under Section 737, the gain recognized will equal the lesser of:

- The "excess distribution"—this is the amount by which the fair market value of the property received (other than money) exceeds the distribute partner's outside basis reduced by any money received; or
- The distribute partner's "net precontribution" gain which is the total amount of built-in gain in all property contributed by the distribute partner during the seven years prior to the distribution that is still held by the partnership at the time of the distribution.

Therefore, when a partnership distributes property other than money to a contributing partner within seven years of such partner's contribution, the partner will be required to recognize the lesser of "excess distribution" or "net precontribution gain."

To illustrate the above: on January 1, 2004, Peyton contributes land with a $50,000 basis and a fair market value of $100,000 to HutHut, FLP. On January 1, 2005, Peyton contributes land with a $80,000 basis and a fair market value of $120,000. On January 1 2007, HutHut, FLP is dissolved and Peyton receives a distribution of a warehouse with a fair market value of $300,000. For purposes of this article, let's assume that Peyton's outside basis is $130,000 ($50,000 and $80,000). Peyton's precontribution gain on January 1, 2007 is $90,000 ($50,000 from the first land contribution and $40,000 from the second land contribution). The value of the warehouse exceeds Peyton's outside basis by $170,000 ($300,000 fair market value less outside basis of $130,000). Since his precontribution gain is less than the excess distribution of $170,000, Peyton will recognize a $90,000 gain upon receiving the warehouse.

Note that a transferee partner steps into the shoes of the transferor partner with respect to computing his pre-contribution gain and with respect to whether he has previously contributed property acquired as a result of a gifted partnership interest. Reg. 1.737-1(c)(2)(iii). Also, if the distribution includes marketable securities, any portion of which is treated like money under Section 731(c), the portion treated like money is ignored for purposes of Section 737. Only the portion of marketable securities not treated as money counts for purposes of Section 737. Section737(e); Reg. 1.731-2(g)(1)(iii). Therefore, to the extent that marketable securities are treated as money under Section 731(c), this has positive results under Section 737 by reducing the amount treated like property, and thus the potential gain under Section 737.

IV. HOW TO DISSOLVE THE PARTNERSHIP.

After you have advised Peyton on the benefits of the partnership, and the tax implications of dissolving, if he still wants to dissolve the Partnership, it is important that you sufficiently advise him of the winding up process. Generally, a partnership must be liquidated and dissolved in accordance with its partnership agreement. The agreement should address *when* the partnership will be dissolved, *who* should be involved, and *how* the dissolution should occur. However, if the dissolution procedure is not fully covered in the agreement or if a statutory provision applies that cannot be overridden, then a partnership must be dissolved in accordance with the BOC. That said, according to Section 153.004 of the BOC, Chapter 11of the BOC, which covers the winding up and termination of domestic entities, cannot be waived or modified by a partnership agreement.

A. When.

In the HutHut, FLP Agreement, a specific article sets forth events which cause an immediate winding up of the Partnership. Like many partnership agreements, this section contains the spirit of Section 11.051 of the BOC which provides that the occurrence of any one of the following events requires a winding up:

- expiration of duration expressed in the governing documents;
- voluntary decision to wind up entity;
- Occurrence of event provided for in governing documents requiring winding up;
- Event specified in the BOC; and
- Judicial decree.

Furthermore, with the intent to supplement the provisions of Section 11.051 of the BOC, Section 11.058 adds:

- a voluntary decision to wind up a partnership requires the written consent of all partners;
- an event of withdrawal of a general partner of a partnership is an event requiring winding up; and
- an event requiring winding up occurs when there are no limited partners.

You determine that Peyton and Eli desire to make a voluntary decision to wind-up the Partnership. The Partnership's governing documents are not requiring the Partnership to expire or dissolve, and no court has ordered the Partnership's dissolution. Therefore, pursuant to the Agreement, all partners must consent to the wind up. That being the case, regardless of how much Peyton and Eli desire to part ways, the dissolution may not occur since it will be necessary for Archie, Olivia, and the brothers to be in favor of the dissolution.

B. Who's in Charge and How it's Done.

A partnership agreement should also specify how the individuals intimately involved in the dissolution process are selected. Sometimes they are referred to as the "liquidating agent." Generally, this would be a partner or partners, or a third party liquidator. Liquidating agents are empowered to: (1) continue to manage any partnership business during the winding up, (2) convey partnership property to third parties or partners, and (3) settle or adjust any claim asserted to be owing by or to the partnership. Moreover, they will be authorized to determine whether to liquidate and sell the partnership assets, or distribute assets in kind to creditors or partners. Further, liquidating agents will be charged with answering the following questions: (1) If assets are distributed in kind, then how will the partners receive them? (2) Will each partner receive a percentage ownership, or will each partner receive whole assets?

If a partnership agreement fails to name a liquidating agent or specify how the liquidating agent will be selected, the partnership must turn to Section 153.502 of the BOC which provides that the winding up shall be accomplished by:

1. The general partners; or
2. If there are no general partners, the limited partners or a person chosen by the limited partners; or
3. A person appointed by a court to carry out the winding up.

Once it is determined who is responsible to implement the dissolution process, the following is a general checklist for winding up a partnership:

1. List of assets and liabilities;
2. Liability payment schedule;
3. Assignment and assumption agreements for existing contracts;
4. Distribution of assets to partners and receipts;
5. Resolutions adopted by the Board of Directors of general partner;
6. Consent of all partners to wind up;
7. Certificate of mailing of notice of winding up; and
8. Certificate of Termination accompanied by a Certificate of Account Status.

Concerning #8 which refers to the only documents filed with the Secretary of State, the Certificate of Termination (Form 651) must be filed with a Certificate of Account Status from the Texas Comptroller of Public Accounts confirming that all taxes under Title 2 of the Tax Code have been paid and that the partnership is in good standing for the purpose of termination. The Certificate of Account Status must confirm the status of the entity through the date of filing with the Secretary of State. For limited partnerships, the certificate of termination must be signed by all general partners involved in the winding up. Section 153.553 of the BOC. If no general partners are participating in the winding up, the certificate should be signed by all nonpartner liquidators or, if the limited partners are winding up the business, by a majority-in-interest of the limited partners. Furthermore, if an entity is submitting the dissolution form, put the name of the signing entity in the "name of entity" line on the form. Otherwise, put the name of the terminating LP on the "name of entity" line.

In the HutHut, FLP Agreement, a protocol is established to appoint the liquidating agent, which under normal conditions will be the general partner. The general partner is an LLC owned by Archie and Olivia which may not be an issue for the brothers, or it may cause them great concern, because, the liquidating agent has authority to use its discretion throughout the winding up process, and will decide, among other things, how the liquidating distributions are made. Therefore, to a degree the partners are at the mercy of the liquidating agent which will control both the tax and non-tax implications. Clearly, before Peyton consents to the dissolution, it is very important for him to understand the steps required for a dissolution and who will handle the process.

V. CONCLUSION

There is a time for everything…a time to be born and a time to die, a time to plant and a time to uproot… a time to keep and a time to throw away… a time to tear and a time to mend. As we assist families today, as a result of ATRA, we are likely to see more uprooting, throwing away, and tearing down of prior planning. Furthermore, it is sad but frequent to see situations like Peyton's where family members fail to get along, and we are often called upon to assist in severing familial business ties. This article has addressed many of the relevant issues present when second and third generation partners are considering a dissolution or withdrawal. Note that most of these issues are present if you are dealing with first generation partners as well. Remember that advice either given or not given by the attorney almost always has a critical impact on tax and nontax consequences. Clients like Peyton need an estate planner who can anticipate and address both tax and non-tax issues of their partnership and the planners that can are truly valuable advisors.

In summary, if a client asks for assistance in dissolving a limited partnership, keep in mind the following as you represent them:

1) Remind the client of the benefits of the partnerships and why the partnership was created initially:

- Control;
- Consolidation of assets;
- Restrictions on transfers of interests;
- Liability protection;
- Positioning for discounts;
- Increased family interaction; and
- Avoidance of ancillary probates.

2) Explain that there may be many good reasons to unwind a partnership, such as:

- Discounts may no longer be needed and by dissolving the partnership, the family can achieve higher basis in partnership assets at the death of family members;
- Avoid or mitigate Strangi[1] and IRC Section 2036(a) arguments (retained life estate arguments);
- Avoid scrutiny of prior gifts;
- Reduce complexity;
- Reduce accounting and legal costs;
- Avoid or mitigate self-employment tax issues; and
- Resolve or prevent family disharmony.

3) Look out for income tax traps:

- IRC Section 704(c)(1)(A)—when a partnership sells assets and distributes cash;
- IRC Section 704(c)(1)(B)—when a partner other than the contributing partner receives property within seven years of the contribution;
- IRC Section 731(c)—when marketable securities are treated like cash; and
- IRC Section 737—when the contributing partner receives property other than the contributed property within seven years of the contribution.

4) If after considering the above, the client still wants to dissolve, explain in detail the dissolution process.

Additionally, if Peyton is unable to dissolve HutHut, FLP, keep in mind that he also has the option to withdraw as a limited partner. Many of the issues pertinent when a partnership dissolves are also present when a partner withdraws because a liquidating distribution occurs. Generally, upon a limited partner's withdrawal, the partner is entitled to receive any distributions due to him pursuant to the terms of the partnership agreement. However, if the agreement fails to address the issue, the partner will be entitled to the fair market value of his interest in the limited partnership as of the date of withdrawal based upon his right to share in distributions at that date.

[1] Strangi v. United States, 5 Cir., 211 F.2d 305

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