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

2 **Benefits of Being a Partner**

- Consolidated Control
- Consolidation of Assets
- Restrictions on Transfers
- Creditor Protection
  - Claims Within a Partnership
  - Claims Outside a Partnership
- Valuation discounts for Transfer Tax Planning
- Reasons for Family Interactions
- Avoidance of Ancillary Probate
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4 **Income Tax Traps to Watch for in a Dissolution or Withdrawal**

- IRC Section 704(c)(1)(A)
- IRC Section 704(c)(1)(B)
- IRC Section 731(c)
- IRC Section 737

5 **General Rule**

Generally, neither a partner nor the partnership recognizes gain or loss on a distribution of money or property to a partner. Section 731(a) and (b) of the IRC

6 **IRC Section 704(c)(1)(A)**

- 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.
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- If a partner contributes property with a fair market value in excess of its adjusted basis and the partnership subsequently sells the asset, the built-in gain must be allocated to the contributing partner.
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Example

- Partnership: HutHut FLP
- Contributions:
  - Peyton: Colorado Real Estate
    - Adjusted Basis: $60,000

- FMV: $100,000
- Ownership as a Result of Contribution:
  - Peyton- 50%
  - Eli- 50%
- Partnership Sells Colorado Real Estate:
  - Purchase Price- $120,000
  - Gain- $60,000
- Allocation of $60,000 Gain
  - $40,000 to Peyton
  - Remaining $20,000 equally to Peyton and Eli per the Partnership Agreement
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8 **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. The distribution is treated like a sale and the sale is deemed to occur at the property's fair market value.

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

Calculation of Gain or Loss

The contributing partner will recognize the lesser of:

1. The built-in gain or loss inherent in the property at the time of contribution; or
2. 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

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Example

- Partnership: Omaha FLP
- Contributions:
  - Peyton: North Lot (Basis: $40,000 and FMV: $100,000)
    South Lot (Basis: $40,000 and FMV: $100,000)
  - Eli: $200,000 Cash
- Ownership as a Result of Contributions:
  - Peyton- 50%
  - Eli- 50%
- Four years later, Partnership distributes North Lot (worth $150,000 at the time) to Eli
- Recognition of Gain:
  - Peyton recognizes the lesser of:
    - North Lot's built-in gain at the time of contribution ($60,000); or

- The amount that Peyton would recognize had the Partnership sold North Lot for its FMV ($60,000 + $25,000 = $85,000).
- Answer: $60,000

11 **IRC Section 731(c)**

- All or some part of distributed marketable securities may be treated the same as a cash distribution.
- 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.

12 **IRC Section 731(c)**

Example

- Partnership: HutHut, FLP
- Peyton's Basis in Partnership: $75,000
- Distribution:
  - Peyton: $50,000 in cash and Treasury Bills valued at $100,000
- Amount treated like cash: $150,000
- Peyton recognized gain:
  - $150,000 - $75,000 = $75,000

13 **IRC Section 731(c)**

Formula for Determining Amount of Deemed Cash

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

14 **IRC Section 731(c)**

Example

- Partnership: AB, LTD
- Ownership:

- Able- 50%
- Baker-50%
- Holdings:
  - Securities X, Y, Z (each worth $100)
  - Basis:
    - X $70
    - Y $80
    - Z $110
- Distribution: X to Able
- Amount treated like cash to Able: $85 ($100 – $15)

15 **IRC Section 731(c)**

WITH X:

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

WITHOUT X:

Security	Value	Basis	Gain/Loss	Able's 50% Share
Y	100	80	20	
Z	100	110	-10	
	200	190	10	5
				$15

16 **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.

17 **IRC 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.

18 **IRC Section 737**

Example

- Partnership: HutHut, FLP
- Contributions:
  - Peyton- 01/01/2004, Real Estate (Basis: $50,000; FMV: $100,000)
    01/01/2005, Real Estate (Basis: $80,000; FMV: $120,000)
- Peyton's Outside Basis: $130,000 ($50,000 + $80,000)
- Dissolution of HutHut, FLP on 01/01/2007
- Distributions:
  - Peyton- Warehouse, FMV: $300,000
- Calculation:
  - Excess Distribution Amount= $170,000 ($300,000 - $130,000)
  - Precontribution Gain= $90,000 ($50,000 + $40,000)
- Peyton will recognize a $90,000 gain.

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