Liquidating Family Partnerships: Avoiding Income and Gift Tax

By
Carol A. Cantrell
Cantrell & Cantrell, PLLC
713-333-0555
ccantrell@cctaxlaw.com

Why Liquidate a Partner's Interest?

- The partnership no longer serves a purpose.
- The partners are at odds with each other.
- The partners' investment goals differ.
- A partner is elderly with a taxable estate and wishes to avoid inclusion of a family controlled entity in his taxable estate.
- As an alternative to gifting or selling additional interests in the partnership.
- To avoid application of the new Sec. 2704 regulations.

General Rule on Taxing Partnership Distributions

- Cash distributions are tax-free up to the partner’s basis in his partnership interest. IRC § 731(a).
- Property distributions are also tax-free. IRC § 731(b).
- Distributed property has the same holding period as the partnership had. IRC § 735(b).

Basis of Distributed Assets

- Current distribution: The basis of the distributed property is the *lesser* of the property's basis in the hands of the partnership or the partner's basis in his *partnership interest.* IRC § 732(a).

- Liquidating distribution: The basis of the distributed property is the partner's basis in his partnership interest less any money distributed in the same transaction. In the case of multiple assets, the basis is allocated according to FMV. IRC § 732(b).

Example of a Property Distribution

Partnership distributes property with a $100,000 basis to Partner A, whose basis in the partnership is $50,000. Partner A recognizes no gain or loss on the distribution. Partner A's basis in the property is limited to $50,000 (his basis in the partnership) and he has zero basis left in his partnership interest.

Partner A's Outside Basis in the Partnership	$50,000
Distribution of Property with a Basis of $100,000	(50,000)
Partner A's Remaining Outside Basis	$ -0-
Partner A's Basis in the Distributed Property	$50,000

Disappearing Basis

- **Query:** What happened to the $50,000 of basis that seemed to "disappear" when it was distributed to Partner A in the previous example?
- Nothing — the IRS is happy when our basis disappears. If the partnership had made a § 754 election, the partnership could increase the basis of its remaining property by the disappeared basis. IRC § 734(a).
- The partnership *<u>must</u> decrease* the basis of its remaining property if it has a "substantial basis reduction" at the time of the distribution. IRC § 734(a), (b).

Substantial Basis Reduction

- A "substantial basis reduction" occurs when:
  - **a partner recognizes a loss on liquidation of his interest of more than $250,000; or**
  - **steps up the basis of property received in a distribution by more than $250,000 over the basis of the property in the hands of the partnership. IRC § 734(d).**
- In that case, the partnership *must reduce* the basis of its other property by the amount of the substantial basis reduction. IRC § 734(a), (b).

Example of Substantial Basis Reduction

Example: Partnership makes a liquidating distribution to Partner A of property with a basis of $50,000. Partner A's basis in his partnership interest is $350,000. Therefore, Partner A's basis in the property is stepped-up to $350,000.

Because Partner A stepped up the basis by more than $250,000, the Partnership must reduce the basis of its other property by $300,000, the amount of his step-up.

Partner A's Outside Basis in the Partnership	$350,000
Liquidating Distribution of Property with a Basis of $50,000	(50,000)
Partner A's Basis in the Distributed Property	$350,000

Distribution of Marketable Securities

- Marketable securities are treated like money and taken into account at fair market value on the date of distribution. IRC § 731(c)(1).
- A partner recognizes gain when the value of marketable securities distributed exceeds his basis in the partnership, just as if it were cash. IRC § 731(a)(1).
- The basis of the distributed securities is the partnership's basis plus the amount of gain recognized by the partner on the distribution. Reg. § 1.731-2(f).

Example of Distribution of Securities

- **Partnership distributes marketable securities worth $500 with a basis of $500 to A in a current distribution. A's basis in the partnership interest is $250. A has a taxable gain of $250 and a $500 basis in the securities, as follows:**

	Gain	A's Basis in Securities	A's Basis in Pship
A's Pre-Distribution Basis	250	250	250
Distribution of Securities	(500)		(500)
Gain Recognized – § 731	250	250	
Basis in Securities – § 732		500	
A's Basis in Pship Interest – § 733			0

Exceptions to Marketable Security Rule

The exceptions swallow the rule. Securities are <u>not</u> treated like money when:

- They are distributed to the contributing partner. IRC § 731(c)(3)(A)(i);
- They were not marketable when contributed to the partnership and were distributed within 5 years of becoming marketable. IRC § 731(c)(3)(A)(ii);
- The partnership is an "investment partnership." IRC § 731(c)(3)(A)(iii); or
- To the extent of the partner's share of appreciation in all of the partnership's marketable securities. IRC § 731(c)(3)(B).

What is an Investment Partnership?

- **An investment partnership is one that has never been engaged in a trade or business other than investing <u>and</u> 90 percent or more of the value of its assets consist of marketable securities. Reg. § 1.731-2(c)(3).**
- **Securities distributed to an "eligible partner" by an investment partnership are not treated like money.**
- **An eligible partner is one who has never contributed any non-investment assets to the partnership. *Id.***

Reduction for Partner's Share of Gain in Marketable Securities

- **Example: A is a 50% partner in AB, which owns $10,000 of marketable securities with a basis of $5,000 and $10,000 worth of other assets. A's basis in AB is $3,000. A receives all of the securities in liquidation of his interest. He recognizes a gain of $4,500, equal to the "money" distributed in excess of his basis, as follows:**

Value of Securities	$10,000
A's 50% Share of Gain	(2,500)
Securities Treated Like Cash	$7,500

	A' Gain
Pship. Basis	$ 3,000
"Cash" Distributed	($7,500)
Gain Recognized	$ 4,500

Distributions Within 7 Years of Contribution

- **There are two "7-year rules" that tax a contributing partner when distributions are made:**
  - If the partnership distributes property to a non-contributing partner within 7 years of its contribution, the contributing partner is deemed to have sold the property to the recipient partner at its FMV on the date of the distribution. IRC § § 704(c)(1)(B).
  - If the contributing partner receives *other* property within 7 years of the contribution, he recognizes gain (but not loss) equal to the FMV of the property received over his basis in the partnership. IRC § 737.

Example of the 7-Year Rule Under Sec. 704(c)(1)(B)

- Six years ago, Partner A contributed land to the partnership with a basis of $10,000 and a value of $20,000. It is now worth $40,000. The partnership distributes the land to Partner B. Partner A is deemed to have sold the land to Partner B for $40,000 and recognizes gain equal to $10,000, which is the lesser of his pre-contribution gain or the gain on the deemed sale.

	Pre-Contribution Gain	Gain on Deemed Sale
FMV	$ 20,000	$ 40,000
Basis	(10,000)	(10,000)
Gain	$10,000	$ 30,000

Example of the 7-Year Rule Under Sec. 737

- Six years ago, Partner A contributed Blackacre to the partnership with a basis of $10,000 and a value of $20,000. A's basis in the partnership is $10,000. A now withdraws Greenacre worth $15,000. A recognizes gain of $5,000, which is the lesser of his pre-contribution gain ($10,000) or the excess of Greenacre's value over A's basis in the partnership ($5,000).

	Pre-Contribution Gain	FMV Over Pship Basis
FMV of Prop'ty	$ 20,000	$ 15,000
Basis in Land	(10,000)	
Basis in P'ship		(10,000)
Gain	$10,000	$ 5,000

When Multiple Rules Apply

- **Sometimes multiple rules apply, especially when liquidating a partnership with marketable securities that were contributed less than seven years ago.**
- **But gain can still be avoided by:**
  - Waiting to liquidate until 7 years after the last contribution of appreciated property;
  - Distributing the pre-contribution gain property to the contributing partners;
  - Avoiding cash distributions in excess of basis;
  - Distributing marketable securities proportionately.

Overview of Prop. Sec. 2704 Regulations

- **On August 4, 2016 the IRS published proposed regulations under Section 2704, which impact partnership redemptions. In general, they provide that:**
  a) Corporations, partnerships, LLCs, S corporations, and other business entities are covered by Sec. 2704, regardless of their federal tax classification;
  b) The lapse of a right to liquidate the entity is an asset includible in the transferor's estate if the lapse occurs less than three years before death;
  c) The transfer of an interest in a family controlled entity will be valued for estate and gift tax purposes by ignoring certain restrictions in the governing documents and under state law.

Effective Date of the Prop. Regs.

- The amendments to existing Regs. § 25.2704-1 and 25.2704-2 are effective for lapses or transfers occurring after the regulations are published as final, which could be anywhere from 6 months to two years from now.
- The new category of "disregarded restrictions" in Reg. § 25.2704-3 is effective for transfers occurring <u>30 days after</u> the regulations are published as final.

Section 2704(a) – The Three-Year Rule

- **If a person with the right to liquidate an entity:**
  - a) transfers, within 3 years of his death, enough of his interest so that he can no longer compel the entity to liquidate; and
  - b) the family controls the entity both before and after the transfer,

  the value of the lapsed right is included in the transferor's taxable estate. Reg. § 25.2704-1(c)(1).
- **This rule will rarely apply because most governing instruments require a unanimous vote to liquidate, and thus no one person has the right to compel a liquidation of the entity, unless they own 100% of the entity.**

Sec. 2704(b) - “Disregarded Restrictions”

- **If a person transfers an interest in an entity to a family member, and the family controls the entity before and after the transfer, we must disregard the following provisions in the governing documents and state law defaults when valuing the transferred interest: Prop. Reg. § 25.2704-3(b)(1)**
  - A provision that limits the holder’s ability to compel liquidation of the interest;
  - A provision that limits the amount the holder may receive on liquidation or redemption to less than minimum value;
  - A provision that defers payment of the proceeds for more than 6 months; and
  - A provision that permits payment of any portion of the proceeds in any manner other than cash or property.

Definitions

- “Transfer’ is not defined in Section 2704. It broadly includes any means by which property rights are passed on or conferred by gift, whether in trust or otherwise, direct or indirect, by bargain sale, by forgiveness of debt, by assignment of benefits, etc. Reg. § 25.2511-1(a).

- “Control” of an entity means ownership of at least 50% of the vote, value, capital, or profits interest or *any interest as a general partner*. IRC § 2704(c); 2701(b)(2).

Definitions (cont.)

- **"Member of the family" with respect to any individual means:**
  - The individual's spouse;
  - Any ancestor or lineal descendant of the individual or their spouse;
  - Any brother or sister of the individual; and
  - Any spouse of the individuals named above.

IRC § 2704(c)(2).

Minimum Value

- "Minimum value" means the FMV of the <u>property held by the entity</u> on the date of the transfer, less any outstanding obligations that were contracted for with full and adequate consideration (i.e. mortgages, etc.). Prop. Reg. § 25.2704-3(b)(1)(ii).
- If an entity has an operating business, minimum value means the amount a willing buyer would pay a willing seller, considering the company's net worth, dividend paying history, earning power and other relevant factors. *Id.*; *see also* Reg. § 25.2512-2(f). In other words, minimum value is <u>going concern value</u>, not liquidation value.

Redemptions As Gifts Under Sec. 2704

- **Example. The family partnership redeems D's 32% interest for FMV. The buy-out price failed to ignore the new "disregarded restrictions." Therefore, D is deemed to have made a gift to the other partners equal to the excess of the hypothetical value of his interest over the redemption proceeds he received. Prop. Reg. § 25.2704-3(g), Ex. 7.**

	Ownership Interest	FMV of the P'ship Property	Value Assuming a 30% Discount	Value of D's Deemed Gift
D's Interest	32%	320,000	224,000	$ 96,000
C's Interest	68%	680,000	476,000	
Total	100%	$1,000,000	$ 700,000	

Opinions Differ on Sec. 2704(b)'s Impact

- "…if the final regulations closely resemble the proposed regulations, minority and marketability discounts will become largely unavailable for family-owned entities." Howard Zaritsky, Probate Practice Reporter, Sept. 2016.
- Nothing in the proposed regulations "is intended to do away with all minority discounts." Cathy Hughes, attorney-adviser, Treasury Office of Tax Legislative Counsel, Tax Notes Today, Oct. 3, 2016.
- Hughes said the regulation requires only that a disregarded restriction be ignored and that practitioners should make no further presumptions. Two otherwise identical fact patterns – one involving a disregarded restriction and one that does not – should result in the same valuation. *Id.*

Sec. 2704(b) Requires a Hypothetical Appraisal

- **"The instruction to disregard existing restrictions that are real and binding on the actual holders of interests in family partnerships forces appraisers to make hypothetical assumptions and render <u>hypothetical appraisals</u>."**

- **"Hypothetical conditions are contrary to known facts about physical, legal, or economic characteristics of the subject property."**

Christopher Mercer, Mercer Capital Business Valuation & Capital Advisory Services, **VALUATION IMPLICATIONS OF THE PROPOSED CHANGES TO SECTION 2704,** Sept. 2016.

More Input From the Appraisal Community

- "The problem with the proposed changes is that they fail to realize that even with no restrictions on transfer, and if all applicable restrictions are ignored and we consider all of the named disregarded restrictions, appraisers are left with illiquid minority interests in family partnerships that have investment characteristics that still require analysis to determine fair market value."

Christopher Mercer, Mercer Capital Business Valuation & Capital Advisory Services, **VALUATION IMPLICATIONS OF THE PROPOSED CHANGES TO SECTION 2704,** Sept. 2016.

What Risk Assumptions Are Left?

- Risk that the family members will not invest to suit the buyer's needs;
- The buyer's inability to control the day-to-day management and/or tax decisions made by the family;
- The risk to the business if any partner can demand liquidation of his interest at any time;
- The likelihood that the partners will not allow a redemption;
- The risk that a C corporation buyer would discount the future cash flow by the income taxes;
- The cost of liquidating the interest, including two appraisals.
- The fact that no rational buyer would buy such an interest.

Tax Return Disclosures

- Even before the regulations are final, taxpayers must disclose a position taken on a tax return that is contrary to the proposed regulations in order for the statute of limitations to run on the transfer. Reg. § 301.6501(c)-1(f)(2)(v).
- Specifically, the regulation provides that: "[a] statement describing any position taken that is contrary to any proposed, temporary, or final Treasury regulations or revenue rulings <u>published at the time of the transfer</u>" must be included in the return.
- The statement would be necessary for gift transfers as well as non-gift transfers occurring after the proposed regulations were issued and state that the proposed regulation is being ignored because it is not yet effective.

Possible Partnership Amendments

- Starting with 2018 tax returns, the "Tax Matters Partner" will become obsolete. Therefore, most partnership agreements should be amended to refer to the new "Partnership Representative" and the unified audit procedures in Secs. 6221-6241. IRC § 6223(a).
- Consider amending the partnership agreement to require a unanimous vote to compel a liquidation, if it does not already do so.
- Consider amending the partnership agreement to define "fair value" for buy-out purposes as the amount determined under generally accepted valuation principles, ignoring the disregarded restrictions, but considering a list of factors that would be relevant to the particular partnership.

Key Takeaways

- Beware of marketable securities and the 7-year rule when making current or liquidating distributions to a partner.
- A redemption for an amount that fails to ignore the disregarded restrictions is a gift to the other partners under Section 2704 if the family controls the entity both before and after the redemption.
- Clients will need two appraisals to comply with the new regulations under Section 2704.
- Practitioners should disclose any position contrary to the proposed 2704 regulations for transfers completed after they are published, even before they are final.