# Report #6

As we have done in January for the last six years, and again with the permission of the University of Miami School of Law Center for Continuing Legal Education, we will be posting to this list throughout the coming week highlights of the proceedings of the 37th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 6-10, 2003 at the Fontainebleau Hilton Resort and Towers in Miami Beach, Florida.

A complete listing of the proceedings and speakers is available on the Institute's Web site. The URL for that site is http://www.law.miami.edu/heckerling.
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REPORT NO. 6

**Unwinding the Discount Entity: What to do When the Family Wants to Take the Money and Run**
**Rich Robinson**
**January 9**

Rich's program describes the tax effects of unwinding an entity taxed as a partnership. He debunks the theory that unwinding or withdrawing property from such a partnership is always a tax free transaction. He discussed and analyzed 3 sections that cause significant headaches in distributing property from the FLP/FLLC:

The general rule under §731 is that no gain is recognized when a partnership distributes property to a partner unless the amount of cash distributed exceeds the distributee's basis for the partnership interest. However, the following sections may create substantial income tax liability if they apply.

§704(c)(1)(B) gain. If partner A contributes appreciated property to a partnership and within 7 years, such property is distributed to another partner, partner A is taxed on the built-in gain (FMV at date of contribution less adjusted basis) as if it was sold by the partnership.

§731 gain. Cash includes marketable securities unless the partnership is an investment company and the distributee is an eligible partner or the distributee partner previously contributed the securities to the partnership. This rule often causes a distribution of marketable securities to be treated as cash, and the FMV of the securities is greater than the distributee partner's adjusted basis.

§737(a) gain. If with 7 years after the date of the contribution, a distribution is made to a partner, such partner shall be treated as recognizing gain in an amount equal to the lesser of the excess distribution (the excess of FMV of the distributed property over the partner's adjusted basis) or the partner's pre-contribution gain. Pre-contribution gain is the 704(c)(1)(B) gain which would be allocated to the partner if <u>all</u> of that partner's contributed property had be distributed to another partner

Rich then discussed several examples and the tax effects of each. Many of the problems arise because of the normal operation of an FLP/FLLC - mom and dad form the partnership and then make gifts, often substantial, to the children. The rules will operate on distributions of property after these gifts and the gain can often exceed the amount of the FMV of the distribution and affect all of the partners, not just the distributee.

A short example (most had numbers associated, and Rich's analysis is quite complete):

Mom contributes assets to an FLP, including a condo. She makes gifts of 30% of the FLP to children. Within 7 years, the condo is distributed back to Mom. Result: 30% of the condo is a 704 (c)(1)(B) taxable distribution with respect to the children and the same 30% would be a §737 taxable distribution to Mom since it is no longer her previously contributed property under the "step into the shoes" rule.

CAVEAT: Before advising a partnership anticipating making a distribution from a partnership, either study the rules or retain competent tax counsel (or both) to make sure the anticipated tax effects are correct.

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