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FLP Distributions

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Many advisors recommend the family limited partnership ("FLP") or LLC as a flexible and effective family-wealth-transfer vehicle, and most taxpayers understand the benefits of utilizing a FLP in their gift and estate planning. However, many fail to consider the income tax consequences of FLP distributions. These distributions represent the economic manifestation of a partner's participation in a FLP yet, too often, advisers and taxpayers do not appreciate the complexity of partnership distributions and their income tax consequences. As a result, some of the transfer tax benefits sought to be attained by using a FLP is, instead, lost to income taxes. Moreover, these income tax consequences are sometimes difficult to identify, but they are generally immediate, so their realization often comes as a surprise.

The following highlights some commonly encountered distribution-related income tax issues of which advisors should be aware.

Contribution and distribution as part of a sale

A transfer of property by a family member to a FLP, and a transfer of money or other consideration by the FLP to the partner may constitute a sale of property by the partner to the FLP if, based on all the facts and circumstances, the transfer of money or other consideration by the FLP to the partner would not have been made but for the contribution of property by the partner and, in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

If within a two-year period a partner transfers property to a FLP and the FLP distributes money to the "contributing" partner, the transfers are presumed to be a sale, unless the facts and circumstances establish otherwise.

Notwithstanding the two-year presumption, a FLP distribution that comes within one of the safe harbors set forth in IRS regulations will be presumed not to be part of a sale of property, unless the facts and circumstances establish otherwise. For example, a "reasonable guaranteed payment" or a "reasonable preferred return" to a contributing family member is presumed not to be part of a sale of property to the FLP.

Special rules are provided for determining whether a transfer of encumbered property is part of a disguised sale in which the assumption of, or taking subject to, the liability is the consideration transferred by the FLP. For example, if the owner of real property encumbers it with a mortgage just before contributing the property to the FLP, the deemed distribution of cash that arises from the contribution may be treated as the payment of consideration by the FLP in exchange for the property unless the liability is a "qualified liability".

Cash and inkind distributions

Where money is distributed by a FLP to a partner, no gain shall be recognized to the partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the FLP immediately before the distribution. A decrease in a partner's share of partnership liabilities, or any decrease in his individual liabilities by reason of the assumption by the partnership of his liabilities, is considered a distribution of money by the FLP.

This rule is applicable to both current distributions and to distributions in liquidation of a partner's entire interest in a FLP. Any gain recognized is considered as gain from the sale of the distributee's FLP interest. The gain from such a sale is generally treated as being from the sale of a capital asset. In general, no gain is recognized to a distributee partner with respect to a distribution of property other than money. There are exceptions to each of these rules.

Liquidations

If the payment is made in liquidation of a partner's entire interest in the FLP, and such payment is not made in exchange for the interest of such partner in the underlying partnership property, then it will be considered as a distributive share of FLP income to the recipient (if the amount is determined with regard to such income) or as a guaranteed payment; in either case, it will be taxed in its entirety as ordinary income (without being offset by the partner's basis in his FLP interest).

If the liquidating payment is made in exchange for the partner's interest in partnership property, then gain will be recognized to the extent the money distributed exceeds the partner's adjusted basis in his FLP interest.

Unrealized receivables

If a partner receives a distribution of partnership property which is an unrealized receivable (or substantially appreciated inventory) in exchange for all or part of his interest in other partnership property (including money), or if the partner receives partnership property (including money) other than unrealized receivables (or substantially appreciated inventory) in exchange for his interest in such receivables (or inventory), such transactions shall be considered as a sale or exchange of such property between the distributee partner and the FLP.

This rule applies to both current and liquidating distributions. It does not apply to a distribution to a partner which is not in exchange for the partner's interest in other property. It does not apply to the extent that a distribution consists of the distributee's share of receivables or his share of other property, without a decrease in his share of the other class of property. It does not apply if the distributed property had been contributed to the FLP by the distributee.


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Marketable securities

A distribution by a FLP of "marketable securities" will be treated as a distribution of money (not as an in-kind distribution). Generally, a marketable security is one that is "actively traded." The amount of the distribution is equal to the fair market value of the securities as of the date of the distribution.

In general, this rule does not apply to a distribution of a marketable security to a partner if the security was contributed to the FLP by such partner. This exception does not apply to the transferee of a contributing partner (e.g., the recipient of a gifted FLP interest).

Nor does the rule apply if the FLP is an "investment partnership" and the distributee partner is an "eligible partner" thereof. An investment partnership is one which has never been engaged in a trade or business and "substantially all" of the assets (by value) of which have always consisted of money, stock, notes, etc., or any combination thereof. An eligible partner is one who did not contribute to the FLP any property other than assets of the kind described above.

Built-in gain property

In general, if a partner contributes appreciated property (i.e., fair market value in excess of its adjusted basis; "built in gain" property) to a FLP, and such property is distributed by the partnership to another partner (not the contributing partner) within seven years of being contributed to the partnership, the contributing partner shall be treated as recognizing gain from the sale of such property, up to the amount of the built in gain, as if such property had been sold at its fair market value at the time of such distribution. The gain recognized by the contributing partner has the same character as the gain that would have resulted if the FLP had sold the distributed property to the distributee.

The transferee of all or a portion of the FLP interest of a contributing partner is treated as the contributing partner for purposes of this deemed-sale rule to the extent of the share of built in gain allocated to the transferee partner. Thus, the rule would not apply to a distribution to such a transferee.

Mixing bowl rule

A partner who contributes appreciated property to a FLP must include the property's built in gain (the "net pre contribution gain") in income to the extent that the value of other property (other than money) distributed by the FLP to that partner exceeds his adjusted basis in his partnership interest (the "excess distribution"). The character of the gain is determined as if the property had been sold by the partnership to an unrelated third party at the time of the distribution. This provision applies only if the distribution is made within seven years after the partner's contribution of the appreciated property to the FLP.

Gain recognition is not required to the extent the FLP distributes property which had previously been contributed to the partnership by the distributee partner.

IRS regulations provide that the transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferee's net contribution gain in an amount proportionate to the interest transferred. It should be noted, however, that the regulation does not provide that the transferee partner is treated as the contributing partner for purposes of this rule.

There is a lot to digest here, and much of it is complex. The foregoing only just touches upon the major distribution-related tax issues. The bottom line is that FLPs remain very flexible and effective tools for holding and transferring family investments or a family business. However, taxpayers need to appreciate, and their advisors must be able to identify, the many potential income tax pitfalls associated with partnerships and, in particular, they must be mindful of the income tax consequences arising from partnership distributions. Only in this way can they plan for them and, hopefully, reduce the adverse economic effects thereof.

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