SUPER-RECOGNITION AND THE RETURN-TO-SENDER EXCEPTION: THE FEDERAL INCOME TAX PROBLEMS OF LIQUIDATING THE FAMILY LIMITED PARTNERSHIP

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INTRODUCTION

In John Godfrey Saxe's poem, *The Blind Men and the Elephant*,[1] six visually impaired men pay a visit to an elephant.[2] Each of the men touches a different part of the elephant, causing a heated debate among them as to whether the elephant is more like a wall, a snake, a spear, a tree, a fan, or a rope.[3] Saxe used the parable to explain differences in world religions,[4] but it can also be used to explain the different views of the family limited partnership. Estate planning practitioners see the family limited partnership as a common technique for utilizing various valuation discounts in effecting efficient transfers of wealth.[5] The Internal Revenue

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[1] John Godfrey Saxe, *The Blind Men and the Elephant*, *in* POETRY OF AMERICA: SELECTIONS FROM ONE HUNDRED AMERICAN POETS FROM 1776 TO 1876, at 150 (William James Linton ed., 1878), *available at* http://books.google.com/books?vid=LCCN28016886&id=hdrGIl0rnhgC&pg=PR5&dq=Poetry+of+America++Saxe%22 www.noogenesis.com/pineapple/blind_men_elephant.html.

[2] *Id.*

[3] *Id.* at 151.

[4] *See id.* at 152.

[5] *See, e.g.*, Lauren E. Bishow, *Death and Taxes: The Family Limited Partnership and its Use in Estate Planning After the Third Circuit's Ruling in* Estate of Thompson v. Commissioner, 50 VILL. L. REV. 1183, 1188–92 (2005); Bradford Updike, *Making Sense of Family Limited Partnership Law After* Strangi *and* Stone: *A Better Approach to Planning and Litigation Through the Bona Fide Transaction Exception*, 50 S.D. L. REV. 1, 7–8 (2005); DAVID T. LEWIS & ANDREA C. CHOMAKOS, THE FAMILY LIMITED PARTNERSHIP DESKBOOK: FORMING AND FUNDING FLPS AND OTHER CLOSELY HELD BUSINESS ENTITIES 4–5 (2004); Elaine Hightower Gagliardi, *Economic Substance in the Context of Federal Estate and Gift Tax: The Internal Revenue Service Has It Wrong*, 64 MONT. L. REV. 389, 433 (2003); Courtney Lieb, *The IRS Wages War on the Family Limited Partnership: How to Establish a Family Limited Partnership That Will Withstand Attack*, 71 UMKC L. REV. 887, 892–93 (2003).

Service (Service) sees the family limited partnership as an elaborate shell game designed to artificially destroy value and, thus, unfairly reduce the federal gift tax or federal estate tax liability associated with wealth transfers.[6] Subchapter K of the Internal Revenue Code (Code), however, sees the family limited partnership as just another everyday partnership;[7] and therein lies the problem.

Ask many estate planners about the income tax aspects of a family limited partnership and you are likely to hear some variation of the following: it is a pass-through entity for federal income tax purposes, meaning the partnership's income is taxed directly to the partners and subsequent distributions of such income will be tax-free.[8] It is tax-free to form and it is tax-free to liquidate.[9] As two-sentence summaries go, this generally works. But it ignores a host of exceptions, three of which arise when the family limited partnership liquidates. After a short discussion of the federal wealth transfer tax aspects of the family limited partnership, Part I of this Article explains the three roadblocks to tax-free liquidation. These roadblocks appear in sections 704(c)(1)(B),[10] 737,[11] and 731(c)[12] of

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[6] *See* Gagliardi, *supra* note 5, at 436. See John W. Porter, *FLP Wars Update: Recent Battles Refine the Rules of Engagement*, TR. & EST., July 2005, at 49 and Leslie A. Droubay, *The Certainty of Death and Taxes for Family Limited Partnerships*, 7 J. SMALL & EMERGING BUS. L. 523, 526–39 (2003), for surveys of the Service's many attacks against the family limited partnership strategy. See David M. Guess, *Disregarding the* Mona Lisa*'s Disappearing Mustache: An Analysis into the Increased Judicial Scrutiny of the Tax Treatment of Family Limited Partnership Interests*, 32 W. ST. U. L. REV. 177, 184–98 (2005) and Katherine D. Black, Stephen T. Black & Michael D. Black, *When a Discount Isn't a Bargain: Debunking the Myths Behind Family Limited Partnerships*, 32 U. MEM. L. REV. 245 (2002), for critiques of the family limited partnership strategy.

[7] *See* I.R.C. §§ 701–777 (2000). For an excellent guide to the major concepts of the federal income taxation of partnerships, see generally LAURA E. CUNNINGHAM & NOËL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS (3d ed. 2006). Perhaps the most significant treatises on the subject are ARTHUR B. WILLIS ET AL., PARTNERSHIP TAXATION (6th ed. 1997) and WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS (3d ed. 1997).

[8] *See, e.g.*, Black et al., *supra* note 6, at 293.

[9] *See, e.g.*, *id.*

[10] I.R.C. § 704(c)(1)(B).

[11] *Id.* § 737.

[12] *Id.* § 731(c).

the Code.[13] Very generally, these provisions often require partners to recognize gain or loss for federal income tax purposes upon a distribution of property from the partnership. Application of one or more of these provisions rebukes the conventional wisdom that a family limited partnership may liquidate on a tax-free basis.

Part II of this Article offers a simple hypothetical case study that will both explain the interaction of the applicable rules and expose two problems that merit correction. The first problem concerns the inconsistent treatment of beneficial assignees. Partners that contribute "built-in gain property"—property with a fair market value in excess of its adjusted basis at the time of contribution—are rightly spared from recognizing such built-in gain if the partnership distributes the built-in gain property back to the contributing partner.[14] This relief comes in the form of a "return-to-sender" exception, which is expressly provided in the Code.[15] But where a contributing partner gifts his or her partnership interest to a beneficiary, the partnership's distribution of the built-in gain property to the beneficiary may present problems. Specifically, the beneficiary is excused from gain recognition under section 704(c)(1)(B) due to a provision in the regulations.[16] But the regulations under section 737 are silent, leading some commentators to conclude that a beneficiary must recognize gain under section 737 when the partnership distributes built-in gain property to the beneficiary even though the beneficiary's assignor would not have to recognize such gain.[17]

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[13] All references to "sections" in the main text of this article refer to the Internal Revenue Code of 1986, as amended. The Internal Revenue Code is codified in Title 26 of the United States Code.

[14] *See* I.R.C. § 704(c)(1)(B) ("[I]f any property so contributed is distributed . . . by the partnership (other than to a contributing partner) . . . the contributing partner shall be treated as recognizing gain or loss . . . .").

[15] *Id.* §§ 704(c)(1)(B), 731(c)(3)(A)(i) (noting the provision requiring gain or loss does not apply when the security is distributed to the contributing partner), 737(d)(1) ("If any portion of the property distributed consists of property which had been contributed by the distributee partner to the partnership, such property will not be taken into account . . . ."). See *infra* Part I.B for a description of the many variations of the return-to-sender exception in these provisions.

[16] *See* Treas. Reg. § 1.704-4(d)(2) (as amended in 2005); *infra* note 64 and accompanying text.

[17] Similarly, there is nothing in the regulations to section 731(c) that extends the return-to-sender exception to the contributing partner's assignee. *See infra* notes 177–82 and accompanying text.

There is no reason to insulate beneficial assignees from gain recognition under section 704(c)(1)(B) only to turn around and subject them to gain recognition under section 737, especially since the Code provides that their assignors would not be subject to gain recognition.[18] Accordingly, this Article urges the Treasury Department (Treasury) to correct the regulations under section 737 so that assignees can qualify for the return-to-sender exception.

The second problem relates to "loss property"—property with an adjusted basis in excess of its fair market value.[19] When a family limited partnership holds both gain property and loss property, in-kind distributions of gain property to some partners coupled with in-kind distributions of loss property to other partners can result in the problem of "super-recognition"—where a partner will have to recognize more gain than the partner would realize upon a fully taxable disposition of his partnership interest.[20] Even though super-recognition initially appears problematic, closer examination reveals that it is the correct result because it is consistent with the results of a sale of gain property by the entity followed by a distribution of the loss property in liquidation of a partner's interest.[21]

But the typical family limited partnership is not formed to engage in disguised sales of assets.[22] Super-recognition is an acceptable result only if one accepts the initial premise that the liquidation should be treated the same as a sale of the assets by the partnership to an unrelated party. This Article proposes that the initial premise is flawed and suggests two ways Congress can cure the problem.

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[18] *See supra* note 15 and accompanying text.

[19] I.R.C. § 704(c)(1)(B).

[20] *See* discussion *infra* Part II.C.

[21] *See* discussion *infra* Part II.C.

[22] *See* Bishow, *supra* note 5, at 1183 (stating that most of the time FLPs are used as estate planning devices to relieve the burden of the federal estate tax); s*ee also* LEWIS & CHOMAKOS, *supra* note 5, at 63 (noting that FLPs have historically been used almost exclusively by estate planning clients focused on planned giving).

I. A SHORT PRIMER ON THE FAMILY LIMITED PARTNERSHIP

A. The Use of Family Limited Partnerships in Contemporary Estate Planning

The term "family limited partnership" is used to describe an arrangement whereby individuals with substantial estates[23] assign investment assets to an entity that will be taxed as a partnership[24] and then transfer ownership interests in the entity to beneficiaries of their choosing.[25] To see how the family limited partnership has become such a lightning rod for controversy, it helps to see the device in action. For this purpose, consider a hypothetical married couple, George and Louise, who reside in a city. Among their many assets, they own several unencumbered parcels of farmland worth an aggregate $3 million and they own stocks in various public corporations worth $7 million. George and Louise form a limited liability company that will be taxed as a partnership. They transfer the farmland and the stock to the limited liability company in exchange for all of the ownership interests in the entity. There are no federal income tax consequences associated with this exchange.[26]

The capital structure of the limited liability company formed by George and Louise consists of one thousand "voting units" and ninety-nine thousand "nonvoting units." Each unit has equal rights with respect to distributions and liquidation of the entity; the only difference between a

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[23] It is often true that the founders of a family limited partnership will have estates in excess of the "applicable exemption amount," the maximum amount of wealth that can pass without imposition of federal estate tax. *See* I.R.C. § 2001(c) (2000 & Supp. I 2001).

[24] *See* Treas. Reg. § 301.7701-3(a)–(b) (as amended in 2005). The entity of choice for this purpose is either a limited partnership or a limited liability company. LEWIS & CHOMAKOS, *supra* note 5, at 2. A limited liability company will generally be treated for federal tax purposes as a partnership unless the owners of the limited liability company elect to have the entity treated as a corporation for federal tax purposes. *See* Treas. Reg. § 301.7701-3(a)–(b).

[25] *See* Gagliardi, *supra* note 5, at 434.

[26] I.R.C. § 721(a) (2000) ("No gain or loss shall be recognized to a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership."). Furthermore, a partner's basis in his or her partnership interest will generally equal the adjusted basis of the property contributed to the partnership. *Id.* § 722. This serves to preserve any built-in gain or built-in loss associated with the contributed assets at the time of contribution.

voting unit and a nonvoting unit is that a voting unit also carries the right to vote on managerial matters concerning the limited liability company.[27]

Following the formation of the limited liability company, George and Louise transfer all or some portion of the nonvoting units to their son, Lionel. Such transfers may be by gift or by sale.[28] Following these transfers, Lionel will have an ownership interest in the entity which, in turn, represents an ownership interest in a portion of the farmland and stock.[29] For instance, if George and Louise transfer ten thousand nonvoting units to Lionel each year for three consecutive years, Lionel will have a combined thirty thousand nonvoting units, representing a 30% capital interest in the limited liability company by the end of the third year. This effectively represents a 30% interest in the farmland and a 30% interest in the stock.

Estate planners would refer to George and Louise's entity as a "family limited partnership" even though the entity is formally a limited liability company and not a limited partnership.[30] In furtherance of their love for acronyms and jargon, many estate planners would simply refer to this arrangement as an "FLP."[31] In the interest of convenience, this Article will follow suit.

George and Louise could have achieved a similar result by conveying to Lionel an undivided 10% interest in each of the parcels of real estate and in each of the various stocks each year for three years.[32] But that would involve substantially more effort, paperwork, and expense.[33] Once the assets have been conveyed to the FLP, George and Louise can make efficient wealth transfers through gifts and sales of nonvoting units instead of gifts and sales by a litany of deed and assignment documents.

Notice, too, that the FLP structure permits George and Louise to convey up to 99% of the total equity in the entity without sacrificing any

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[27] *See* LEWIS & CHOMAKOS, *supra* note 5, at 124 (stating that nonvoting members have no control over management of the company).

[28] *See* I.R.C. § 704(e).

[29] *See supra* note 25 and accompanying text.

[30] *See supra* note 24 and accompanying text.

[31] *See, e.g.*, Porter, *supra* note 6, at 49; Black, *supra* note 6, at 248; Droubay, *supra* note 6, at 523; Bishow, *supra* note 5, at 1183.

[32] *See* HERBERT HOVENKAMP & SHELDON F. KURTZ, THE LAW OF PROPERTY 563, 566 (5th ed. 2001).

[33] *See id.* For instance, each conveyance of an interest in real property requires a written deed containing a description of the property as well as delivery of the deed to the grantee. *Id.*

voting control over the entity.[34] Were George and Louise to convey an undivided 99% tenancy-in-common interest[35] in each parcel of farmland and each share of stock to Lionel, they would effectively lose their ability to control the disposition and everyday management of those assets.[36] Thus, the FLP offers the additional advantage of retained control to the founders.

But perhaps the most important advantage to the FLP, at least from a tax perspective, relates to valuation. Had George and Louise transferred an undivided 30% interest in each of the farmland properties and the various stocks, the fair market value of the wealth transfer would likely be in the neighborhood of $2.55 million, assuming a 15% fractional interest discount.[37] But because George and Louise instead transfer a 30% interest in the FLP in the form of nonvoting units, the fair market value of the transfer will reflect the lack of voting rights and the fact that the nonvoting units are not readily marketable.[38] The blended discount will most likely exceed 15% and might even approach 50%.[39] Assuming a relatively modest 35% blended discount, the fair market value of the wealth transfer to Lionel is only $1.95 million, a full $600,000 less. If George and Louise make the transfer by gift, it means the taxable gift is considerably less;[40] if

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[34] *See* LEWIS & CHOMAKOS, *supra* note 5, at 124.

[35] 20 AM. JUR. 2D. *Cotenancy & Joint Ownership* § 32 (2006).

[36] Each tenant has a right to control his or her portion of the property in a tenancy-in-common arrangement. *See* HOVENKAMP & KURTZ, *supra* note 32, at 115.

[37] This is a reasonable discount for a fractional interest in property. *See* Neil E. Harl & Roger A. McEowen, *The Family-Owned Business Deduction—Section 2057*, 829-2d TAX MGMT. (BNA) (2001) ("[F]ractional interest discounts typically range from 10% to 25% of the prediscounted value of the underlying property.").

[38] *See, e.g.*, Bishow, *supra* note 5, at 1189; Updike, *supra* note 5, at 7.

[39] *See, e.g.*, Estate of Kelley v. Comm'r, 90 T.C.M. (CCH) 369, 374 (2005) (allowing a 12% minority interest discount and a 23% discount for lack of marketability); Lappo v. Comm'r, 86 T.C.M. (CCH) 333, 339–40 (2003) (applying a 15% minority interest discount and a 24% marketability discount); McCord v. Comm'r, 120 T.C. 358, 387, 395 (2003) (allowing a 15% minority interest discount and a 20% marketability discount); Estate of Campbell v. Comm'r, 62 T.C.M. (CCH) 1514, 1516, 1523 (1991) (calculating a combined minority and lack of marketability discount of 57%); Bright v. United States, 658 F.2d 999, 1008 (5th Cir. 1981) (allowing 50% combined discount).

[40] Depending on the extent to which George and Louise have made prior taxable gifts, the discount could save up to $276,000 in federal gift tax (assuming the gift is made in 2006, the maximum rate of taxes on gifts is 46%). I.R.C. §§ 2001(c), 2502(a) (Supp. I 2001).

Lionel is purchasing the units, he is paying less. While Lionel will be entitled to the same net amount upon liquidation of the FLP ($3 million) as he would if he held an undivided 30% interest in each of the underlying investment assets, the wealth transfer taxes associated with the transfers will be significantly less.[41]

FLP arrangements, therefore, allow the marketability and minority interest discounts normally applicable to business interests to apply to investment assets by assigning such assets to a business entity. The Service has opposed this application of the business-related discounts to investment assets through use of the FLP device.[42] Only recently has the Service found success in litigation, though planners can often structure FLPs to avoid these precedents.[43]

Understandably, commentators focus their attention on the federal wealth transfer tax aspects of FLPs. Considerably less attention is paid to the income tax consequences of FLPs. That may be because the formation, operation, and liquidation of partnerships is generally streamlined from an income tax perspective. Transfers of property to the FLP at formation generally do not give rise to income tax liability.[44] Income generated by the FLP's assets is taxed directly to the owners,[45] and subsequent distributions of such income are generally tax-free.[46] As a result, the income of the FLP is taxed only once, not twice like the income of a corporation.[47] And in many cases, the owners of an FLP can liquidate the entity without incurring income tax liability.[48] From an income tax perspective, then, FLPs are largely "tax nothings."

Yet, as Part B will show, there are up to three income tax traps lurking upon liquidation of the FLP. With all of the attention given to the transfer

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[41] *See supra* notes 37–40 and accompanying text.

[42] *See supra* note 6 and accompanying text.

[43] For a description of the Service's recent victories and the strategic measures practitioners have developed in response to these victories, see generally S. Stacy Eastland, *Family Limited Partnerships: Current Status and New Opportunities*, *in* ALI-ABA COURSE OF STUDY MATERIALS 2006 (Planning Techniques for Large Estates, Course Number SL078, 2006), *available at* LEXIS, Secondary Legal, Combined ALI-ABA Course of Study Materials.

[44] I.R.C. § 721(a) (2000).

[45] *Id.* § 701.

[46] *Id.* § 731(a).

[47] For a guide to the double taxation of corporations, see LEANDRA LEDERMAN, UNDERSTANDING CORPORATE TAXATION (2d ed. 2006).

[48] *See supra* notes 9–12 and accompanying text.

tax aspects of FLPs, these traps are easy to miss. But when sprung, they undermine the net tax benefits the partners and their advisors originally sought.

B. Income Tax Aspects of Liquidating the Family Limited Partnership

Like any partnership, the partners of an FLP have two basic options for unwinding or dissolving the entity: sell the entity's assets and distribute the cash remaining after payment of debts to the partners, or distribute the entity's assets in kind to the partners.[49]

1. Asset Sale and Cash Distribution

Section 704(c)(1)(A) requires any gain from the sale of appreciated property contributed to a partnership to be allocated among the partners in a manner that takes into account the property's built-in gain at contribution.[50] Generally, such built-in gain must be allocated to the contributing partner;[51] any gain in excess of the built-in gain (attributable to post-contribution appreciation) may be allocated as the partners agree.[52]

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[49] *See* Richard M. Lipton, *Critical Partnership Tax Issues—An Overview*, *in* TAX LAW & PRACTICE 2005, at 11, 35–36 (PLI Tax Law & Estate Planning, Course Handbook Series No. J-646, 2005) (citing various provisions of the Uniform Limited Partnership Act and the Revised Uniform Limited Partnership Act). Dissolution is common where the partnership assets are underperforming, or shortly following the death of the surviving founder. *See id.* Moreover, if the proposed repeal of the federal estate tax comes to pass, one can expect more dissolutions come 2010. *See* I.R.C. § 2210 (Supp. II 2002). Yet, no matter whether the founding partners are alive, income tax traps are ready to spring if liquidation occurs within seven years of the founding partners' contributions to the entity. *See id.* § 704 (c)(1)(B) (2000).

[50] I.R.C. § 704(c)(1)(A).

[51] *See* Treas. Reg. § 1.704-3(a)(1) (as amended in 2005) ("The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss."). If the built-in gain has already been accounted for through the use of "remedial allocations," there is no need to allocate the built-in gain a second time to the contributing partner. *See id.* § 1.704-3(d).

[52] *See id.* § 1.704-(3)(a)(1) (requiring only the use of a reasonable method of allocation consistent with the purposes of section 704(c)). In the author's experience, it is common for FLP agreements to provide that any gain in excess of the I.R.C. section 704(c)(1)(A) built-in gain must be allocated to the partners in proportion to their partnership interests. This allows the partnership interests to avoid the "zero-value" rule of I.R.C. section 2701. *See* RICHARD B. STEPHENS ET AL., FEDERAL ESTATE & GIFT TAXATION: INCLUDING THE GENERATION-SKIPPING TRANSFER TAX 19-11 (8th ed. 2002). The zero-value rule values retained interests in certain gift transfers of subordinated equity interests to applicable

(*continued*)

Those who succeed to all or a portion of a contributing partner's partnership interest inherit that share of the built-in gain attributable to the interest received.[53]

Following recognition and pass-through of gains and losses from the sale of the FLP's assets and the required adjustments to each partner's "outside basis" (the partner's basis in the partnership interest),[54] a distribution of the remaining cash proceeds by the partnership to the partners is taxable only to the extent that the distributed cash exceeds a partner's outside basis.[55]

2. In-Kind Distributions to Partners

In lieu of a sale of the FLP's assets, the partners might decide to dissolve the entity by distributing the assets to the partners. In this regard, the owners again have two options: proportionate (or "pro rata")

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family members at zero, meaning the donor is deemed to make a gift in an amount equal to the value of the entire equity interest and not simply the value of that portion actually passing to the donee. *Id.* at 19–12. If the partners agree to allocate the excess gain in a manner disproportionate to their interests in the partnership, there is a risk that they may be creating subordinated equity interests that could trigger the zero-value rule.

In addition, disproportionate allocation of the gain may violate I.R.C. section 704(e)(2). This provision states that upon the gift of a limited partner interest in an FLP, the donee's distributive share of the FLP's income (including items of gain) is limited in two ways: (1) the donor must be adequately compensated for any services rendered to the FLP; and (2) if the donee's interest was funded with donated capital, the donor and the recipient must be allocated income in proportion to the donated capital. I.R.C. § 704(e)(2). In effect, the maximum (and minimum) income allocable to a donee-partner is the income allocable to the recipient partner's interest in partnership capital. Combining the two rules under I.R.C. section 704(e)(2), the regulations state that family partnership income must be distributed proportionate to capital interests after distributing reasonable compensation to the donor for services rendered to the FLP. Treas. Reg. § 1.704-1(e)(3)(b).

[53] Treas. Reg. § 1.704-3(a)(7).

[54] I.R.C. § 705(a). Specifically, a partner's outside basis is increased by the partner's share of partnership income and gain items (whether taxable or tax-exempt) and reduced by the partner's share of partnership losses and expenditures (no matter whether they are deductible). *Id.*

[55] *Id.* § 731(a)(1). Where the FLP recognizes substantial gains at liquidation, the upward adjustments to outside basis, *see supra* note 54, will almost always give the partners sufficient outside basis to cover the cash distributions. Distributed cash reduces a partner's outside basis. *Id.* § 733(1). If there is any remaining outside basis after accounting for all liquidating distributions, the partner may recognize such remaining outside basis as a loss. *See id.* § 731(a)(2).

distributions of each asset—wherein each partner receives a share of every asset according to the partner's interest in the FLP—or disproportionate ("cherry-picking") distributions of the assets—where entire assets are distributed to one partner to the extent possible.[56] Depending on this choice and upon the composition of the FLP's assets, up to three Code provisions can come into play upon an in-kind distribution to a partner.

a. Section 704(c)(1)(B) Built-in Gain

Section 704(c)(1)(B) provides that if property distributed to one partner was contributed to the FLP by another partner within seven years of the distribution, and if that property had built-in gain or loss at the time of contribution, then the contributing partner must recognize the built-in gain or loss at the time of the distribution.[57] Suppose, for example, that Dad and Daughter formed an FLP. In year one, Dad contributed farmland worth $500,000 and with an adjusted basis of $300,000 in exchange for a 5% general partner interest[58] and a 45% limited partner interest.[59] Daughter contributed cash in the amount of $500,000 for a 50% limited partner interest. In year five, the FLP distributed the farmland to Daughter. Assuming no appreciation in the value of the land, Dad must recognize his $200,000 built-in gain from the farmland in year five.[60]

When the contributing partner assigns his or her partnership interest to a beneficiary, the beneficial assignee steps into the contributing partner's

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[56] For example, suppose FLP owns two assets at liquidation: Blackacre, a parcel of investment property worth $600,000, and $400,000 in marketable securities. FLP has two partners: Dad, with a 5% general partner interest and a 35% limited partner interest, and Son, with a 60% limited partner interest. If Dad, as general partner, opts for a proportionate distribution of the assets, Dad will receive a 40% interest in Blackacre and a 40% interest in the marketable securities, while Son will receive a 60% interest in both assets. If Dad opts for disproportionate distributions, Dad could receive all of the marketable securities while Son takes all of Blackacre.

[57] I.R.C. § 704(c)(1)(B).

[58] A general partner takes part in the management of the partnership, shares in profits and losses, and is personally liable for partnership debts and liabilities. BLACK'S LAW DICTIONARY 1152 (8th ed. 2004).

[59] A limited partner cannot take part in managing the business and is not liable for the partnership's debts and liabilities but is still entitled to receive partnership profits. *Id.*

[60] *See* I.R.C. § 704(c)(1)(B). The character of this gain is determined at the FLP level. *Id.* § 702(b). Thus, if the farmland is a capital asset in the hands of the FLP, as is likely the case, the resulting gain will be capital gain.

shoes for purposes of section 704(c)(1)(B).[61] Thus, in the above example, if Dad gave his general and limited partner interest to Son in year four, FLP's distribution of the farmland to Daughter would cause Son to recognize the $200,000 built-in gain in year five.[62]

Recognition of the built-in gain or loss is avoided if the property is distributed back to the contributing partner.[63] For purposes of this "return-to-sender exception," any assignee or successor to the contributing partner's interest is treated as the contributing partner to the extent of the built-in gain or loss allocable to the assignee-successor's interest.[64] So if Dad gave his general and limited partner interest to Son in year four, FLP's year five distribution of the farmland to Son would not trigger recognized gain to either Son or Dad under section 704(c)(1)(B) because Son is Dad's assignee.[65]

Recognition of the built-in gain is also avoided when all partners have section 704(c) built-in gain in proportion to their partnership interests and the partners effect a pro rata distribution of the entity's assets.[66] A slightly modified example can illustrate this rule. Suppose Mom and Uncle formed an FLP in year one by contributing farmland worth $1 million. Their combined basis in the contributed property was $200,000. In year five, Mom and Uncle gave all of their interests in the FLP in equal shares to Son and Daughter. In year six, the FLP distributed the farmland in equal shares to Son and Daughter in liquidation of their interests. Because Son and Daughter are treated as the contributors of the farm under the successor-in-interest rule,[67] and because the property is distributed to the partners in proportion to their shares of the built-in gain, section 704(c)(1)(B) does not apply and neither partner recognizes any portion of the $800,000 built-in gain.[68]

There are few options for avoiding the application of section 704(c)(1)(B) if the partners do not want built-in gain property to come back to the contributing partner or the contributing partner's assignee. The easy solution is to wait seven years before making any distributions of

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[61] Treas. Reg. §§ 1.704-3(a)(7), 1.704-4(d)(2) (as amended in 2005).

[62] *Id.* § 1.704-4(d)(2).

[63] I.R.C. § 704(c)(1)(B).

[64] Treas. Reg. § 1.704-4(d)(2).

[65] *See id.*

[66] *See id.* § 1.704-4(c)(6).

[67] *See id.* § 1.704-4(d)(2).

[68] *See id.* § 1.704-4(c)(6).

contributed property that carry built-in gain.[69] But very often the partners, anxious to effect the liquidation and go their separate ways, will not heed this advice.

b. Section 737 Gain Recognition to Contributing Partner

Section 737 generally provides that if a partner contributes appreciated property to the FLP, and within seven years of such contribution receives a distribution of noncash property, the contributing partner must recognize the section 704(c) built-in gain (or, if less, the excess of the distributed property's value over the partner's outside basis immediately prior to the distribution minus any cash received in the same distribution).[70] Figure 1 expresses the amount of gain recognized by the contributing partner as the *lesser of* two amounts, the "excess distribution" amount and the "net precontribution gain" amount.[71]

Figure 1: Section 737(a) in Formula Form

Section 737(a)(1) Amount: Excess Distribution
Fair market value of noncash property distributed to contributing partner
less Contributing partner's "reduced outside basis" (outside basis less cash in same distribution)
"Excess distribution"
Section 737(a)(2) / Section 737(b) Amount: Net Precontribution Gain
Amount of section 704(c)(1)(B) gain allocable to contributing partner
if all section 704(c) assets were distributed to other partners

To illustrate, suppose Dad and Daughter formed an FLP in year one. Dad contributed farmland worth $500,000 (in which Dad's adjusted basis was $300,000) in exchange for a 5% general partner interest and a 45% limited partner interest. Daughter contributed cash in the amount of $500,000 for a 50% limited partner interest. Soon after formation, the FLP used the cash to acquire a collectible. In year five, the FLP distributed the collectible to Dad. Assuming the value of the contributed properties has

[69] *See* I.R.C. § 704(c)(1)(B) (2000).

[70] *See id.* § 737(a)–(b). This statute does not allow for the recognition of built-in loss. *Id.* Consequently, where a partner contributes property to the FLP with an adjusted basis in excess of its fair market value at the time of contribution, a subsequent distribution of noncash property to the contributing partner within seven years will not permit the contributing partner to recognize any portion of the built-in loss. *Id.* Instead, such loss will be preserved in the basis of the distributed property, assuming the partnership's basis in the property has remained constant since contribution. *See id.* §§ 723, 732(a)(1).

[71] *Id.* § 737(a).

not changed since contribution, Dad must recognize his $200,000 built-in gain from the farmland in year five.[72]

As was the case with section 704(c)(1)(B), an assignee-successor to a contributing partner's interest is treated as a contributing partner for purposes of section 737's general rule.[73] Thus, in the prior example, if Dad gifted his general and limited partner interests to Son in year four, the FLP's distribution of the collectible to Son in year five would force Son to recognize the $200,000 built-in gain from Dad's contribution of the farmland in year one.[74]

On its face, section 737(a) would apply if the contributing partner received back from the FLP the appreciated property originally contributed to the partnership.[75] Regulations recognize that because such a "return-to-sender" distribution is not taxable under section 704(c)(1)(B), section 737 does not apply if the contributing partner receives the property he originally contributed to the FLP.[76] Oddly, however, there is no rule providing that an assignee-successor to the contributing partner's interest likewise qualifies for this exception; on this point the regulations are ominously silent.[77] It is therefore possible that an assignee-successor must recognize gain under section 737 upon receipt of property originally contributed to the FLP by the assignee-successor's predecessor in interest, even though the receipt of the contributed property by the same party is expressly *not* subject to section 704(c)(1)(B).[78]

c. Section 731(c) Treatment of Marketable Securities as Cash

Section 731(a)(1) generally provides that partners do not recognize gain upon a distribution from a partnership except to the extent that any cash received in the distribution exceeds the recipient partner's outside

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[72] *See id.* If the value of the collectible at the time of distribution had declined to $400,000, Dad would have to recognize only $100,000 of the built-in gain from the farmland in year five. This is because the I.R.C. section 737(a)(1) excess distribution amount would be less than the I.R.C. section 737(a)(2) net precontribution gain amount. *Id.*

[73] Treas. Reg. § 1.737-1(c)(2)(iii) (as amended in 2005).

[74] *See id.*

[75] *See* I.R.C. § 737(a).

[76] *See* Treas. Reg. § 1.737-2(d)(1).

[77] *Compare id.* § 1.704-4(d)(2), *with id.* §§ 1.737-1 to 1.737-5.

[78] For a contrary view, see Ellen K. Harrison and Brian M. Blum, *Another View: A Response to Richard Robinson's "'Don't Nothing Last Forever'—Unwinding the FLP to the Haunting Melodies of Subchapter K"*, 28 AM. C. TR. & EST. COUNS. J. 313, 315 (2003).

basis immediately prior to the distribution.[79] For purposes of this rule, however, section 731(c) provides that marketable securities are treated as cash (valued at fair market value as of the date of distribution).[80] Suppose, for example, that Mom and Son formed an FLP when Mom contributed a collectible with a value of $100,000 and a basis of $20,000, and Son contributed $100,000 cash. The FLP used $50,000 of the cash to purchase shares of Microsoft stock. The FLP then distributed the Microsoft stock to Mom. Under section 731(c), the stock distribution is treated as a cash distribution in the amount of $50,000, the value of the Microsoft shares distributed.[81] Mom must recognize a gain of $30,000 because the amount of deemed cash distributed exceeds her $20,000 outside basis.[82]

By its terms, there are four exceptions to the application of section 731(c).[83] The general rule does not apply when: (1) the marketable securities received by the partner were those contributed by the same partner (another return-to-sender exception);[84] (2) subject to some limitations, the marketable securities distributed were acquired by the partnership in a nonrecognition transaction;[85] (3) the distributed securities were not marketable when first acquired by the partnership and did not become marketable for at least six months;[86] or (4) the partnership is an

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[79] I.R.C. § 731(a).

[80] *Id.* § 731(c)(1).

[81] *See id.*

[82] *See id.* § 731(a)(1). Mom's outside basis would be $20,000—her adjusted basis in the collectible. *See id.* § 722. This result assumes no interim income and no other events that would adjust Mom's outside basis. *See id.* § 705.

[83] *Id.* § 731(c)(3).

[84] *Id.* § 731(c)(3)(A)(i).

[85] Treas. Reg. § 1.731-2(d)(1)(ii) (as amended in 1997). The total cash and marketable securities acquired by the partnership in the nonrecognition transaction must be less than 20% of the value of the assets transferred by the partnership in the transaction. *Id.* Furthermore, the distribution of the marketable securities must be occurring within five years of the partnership's acquisition of the securities (or, if later, within five years of the date upon which the securities became marketable). *Id.*

[86] I.R.C. § 731(c)(3)(A)(ii); Treas. Reg. § 1.731-2(d)(1)(iii). Also, the partnership must be distributing the securities within five years of the date upon which they became marketable. Treas. Reg. § 1.731-2(d)(1)(iii). Moreover, the issuer of the securities must not have issued any marketable securities prior to the time the partnership first acquired the distributed securities. *Id.* Isn't this fun?

"investment partnership" and the recipient of the distribution is an "eligible partner."[87]

This last exception requires elaboration. A partnership will qualify as an investment partnership if it has never been engaged in a trade or business and 90% or more of its assets, measured by value, have always consisted of portfolio assets.[88] An eligible partner is any partner that contributed nothing to the partnership but such portfolio assets.[89] Presumably, then, individuals with substantial estates would be well-advised to form FLPs with nothing but portfolio assets so as to qualify for this last exception to section 731(c). However, this poses its own problems at the time of formation. Even though the formation of an FLP is usually not a taxable event,[90] section 721(b) requires recognition of gain (but not loss) when: (1) more than 80% of the value of the partnership's assets consists of portfolio assets held for investment;[91] and (2) the partner's contribution of property to the partnership results in diversification of the partner's investment interest.[92] Thus, one could accidentally trigger recognition of gain at formation of an FLP by trying to ensure that the FLP qualifies for the investment partnership exception to section 731(c).

For example, suppose Mom and Daughter decide to form an FLP. Mom transfers to the FLP marketable securities worth $900,000 and an adjusted basis of $200,000 in exchange for a 5% general partner interest and an 85% limited partner interest. Daughter transfers $100,000 cash to

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[87] I.R.C. § 731(c)(3)(A)(iii).

[88] *Id.* § 731(c)(3)(C)(i); Treas. Reg. § 1.731-2(c)(3)(i). The Code specifically defines portfolio assets to include (among other things) cash, stock in a corporation, notes, bonds, debentures, other evidence of indebtedness, certain notional principal contracts, and foreign currency. I.R.C. § 731(c)(3)(C)(i).

[89] I.R.C. § 731(c)(3)(C)(iii); Treas. Reg. § 1.731-2(e)(2)(i). This is a cumbersome and vague definition. It certainly excludes a partner that contributes nonportfolio assets (land, collectibles) to the FLP. *Id.* Does it also exclude those who made no contributions to the FLP at all but instead acquired their partnership interests by gift or purchase? Because those noncontributing partners "did not contribute to the partnership any property other than [portfolio] assets," I.R.C. § 731(c)(3)(C)(iii)(I), it would seem that they would qualify as eligible partners.

[90] I.R.C. § 721(a).

[91] *See id.* §§ 721(b), 351(e)(1); Treas. Reg. § 1.351-1(c)(1) (as amended in 1996). While section 351 cites to a different definition of "portfolio assets" for this purpose, the definition is consistent with the one discussed *supra* note 88. *See* I.R.C. §§ 351(e)(1), 721(b).

[92] *See* I.R.C. § 721(b); Treas. Reg. §§ 1.351-1(c)(1), 1.351-1(c)(5).

the FLP in exchange for a 10% limited partner interest. Because more than 80% of the value of the FLP's assets consists of portfolio assets,[93] and because the transfers by Mom and Daughter result in the diversification of their investments (the parties transferred dissimilar assets to the FLP in exchange for the interests),[94] Mom must recognize a $700,000 gain. Mom or Daughter (or both) will have to contribute a sufficient amount of nonportfolio assets to avoid this result,[95] but doing so will sacrifice the investment partnership exception to section 731(c), as less than 90% of the FLP's assets will be portfolio assets.[96] A subsequent distribution of marketable securities to Daughter will more likely be treated as a distribution of cash.

Under section 731(c)'s variation of the return-to-sender exception, marketable securities will not be treated as cash for purposes of section 731 if they are distributed to the same partner that contributed them to the FLP.[97] This is consistent with the exceptions under sections 704(c)(1)(B) and 737.[98] But here, too, just like section 737,[99] there is no rule extending the exception to a distribution of marketable securities to an assignee-successor to the contributing partner's FLP interest.[100] In other words,

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[93] Remember that cash is a portfolio asset under the definition applicable to I.R.C. sections 731(c), 721(b), 351(e)(1).

[94] *See* Treas. Reg. § 1.351-1(c)(5).

[95] There are some exceptions to the gain recognition requirement under I.R.C. section 721(b). *See* I.R.C. §§ 721(b), 351(e)(1); Treas. Reg. § 1.351-1(c)(5). For instance, if Mom and Daughter contribute substantially identical assets to the FLP, no diversification results; and thus, Mom's gain need not be recognized. Treas. Reg. § 1.351-1(c)(5). In considering this option, "insignificant" transfers of nonidentical assets can be ignored for purposes of determining whether diversification has occurred. *Id.* § 1.351-1(c)(7), Ex. (1). Treasury has formally stated that where a founding partner contributes nonidentical assets worth only 0.99% of the total amount transferred to the entity at formation, the *de minimis* contribution could be ignored. *See id.* Informally, the Service has ruled that a transfer of nonidentical assets comprising less than 5% of total value contributed at formation is likewise insignificant. I.R.S. Priv. Ltr. Rul. 200006008 (Sept. 30, 1999). Beyond that, one is left to guesswork. Although, the Service has ruled that a transfer of nonidentical assets worth 11% of the total contribution at formation is *not* insignificant. Rev. Rul. 87-9, 1987-1 C.B. 134.

[96] *See* Treas. Reg. § 1.731-2(c)(3)(i).

[97] I.R.C. § 731(c); Treas. Reg. § 1.731-2(d)(1)(i).

[98] I.R.C. §§ 704(c)(1)(B), 737(d)(1).

[99] *See supra* note 77 and accompanying text.

[100] Treas. Reg. § 1.731-2(d)(1) ("[S]ection 731(c) and this section do not apply to the distribution of a marketable security if—(i) the security was contributed to the partnership

(*continued*)

those who receive a partnership interest by gift may have to recognize gain upon a distribution of marketable securities from the FLP even if those securities were contributed to the FLP by their respective donors.[101] What makes this rule even worse is that its application does not expire after seven years.[102]

Where section 731(c) applies, the amount of the deemed cash distribution is reduced by the recipient partner's share of gain on the distributed securities.[103] The amount of the deemed cash distribution can be determined under the formula set forth in Figure 2.

Figure 2: Deemed Cash Distribution under I.R.C. section 731(c)[104]

Fair market value of distributed securities
less Distributee's share of net *gain* on sale of all partnership marketable securities
plus Distributee's share of net *gain* on sale of *retained* partnership marketable securities
Amount of deemed cash distribution

The effect of this formula is to tax the recipient partner on *all but* his share of the built-in gain attributable to the distributed securities.[105] For example, assume that Brother and Sister are equal partners in an FLP.[106] The partnership owns three marketable securities: Microsoft (inside basis[107] of $70,000), Costco (inside basis of $80,000), and Boeing (inside basis of $110,000). Each security is worth $100,000 ($300,000 total). The

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by the distributee partner . . . ."). No mention is made of a successor in interest here. *See id.*

[101] *Id.*

[102] *Compare* I.R.C. § 731, *with id.* §§ 704(c)(1)(B), 737(b)(1) (using a seven-year expiration on the application of similar rules).

[103] I.R.C. § 731(c)(3)(B); Treas. Reg. § 1.731-2(b)(2).

[104] I.R.C. § 731(c)(3)(B).

[105] *See* Treas. Reg. § 1.731-2(b)(3)(iii). Treasury states that the purpose of this rule is to permit the tax-free withdrawal of the recipient partner's share of the appreciation in the marketable securities but to force recognition where the partner is effectively trading his share of appreciation in other assets in exchange for the marketable securities. Distribution of Marketable Securities by a Partnership, 61 Fed. Reg. 28 (Jan. 2, 1996) (to be codified at 26 C.F.R. pt. 1).

[106] This example is adapted from Treas. Reg. section 1.731-2(j), Ex. (2).

[107] "Inside basis" refers to a partner's share of the adjusted basis in partnership assets, and "outside basis" refers to the adjusted basis of a partner's interest in the partnership. *E.g.*, Treas. Reg. § 1.705-2(a). The partnership's initial inside basis in an asset contributed to the partnership is equal to the contributing partner's adjusted basis in the asset at the time of contribution. I.R.C. § 723.

FLP distributes the Microsoft stock to Brother. The FLP's net gain from the sale of all three securities would be $40,000, and Brother's distributive share of that gain would be $20,000.[108] If the FLP sold only the Costco stock and the Boeing stock, its net gain would have been $10,000 and Brother's share of that gain would be $5,000.[109] Accordingly, the amount of the deemed cash distribution to Brother is $85,000 ($100,000 value of the Microsoft stock, less Brother's $20,000 share of the gain from a sale of all FLP securities, plus Brother's $5,000 share of the gain from a sale of the two retained securities).[110]

d. Ordering Rules

Because one, two, or all three of the Code provisions described above may be triggered upon the liquidation of a family partnership,[111] there must be some mechanism for sorting out how these provisions interact so that the same targets are not taxed twice. The regulations provide such an ordering rule.[112] Under this rule, one first applies section 704(c)(1)(B),[113] which provides that a contributing partner recognizes the built-in gain or loss from contributed property if such property is distributed to another partner within seven years of the contribution.[114] Remember that section 704(c)(1)(B) contains a return-to-sender exception that applies not only to the contributing partner but also to the contributing partner's assignee.[115]

Second, one applies section 731(c),[116] which treats a distribution of marketable securities to a partner as a distribution of cash.[117] Accordingly, under section 731(a), the distribution will be taxable to the extent it exceeds the recipient partner's outside basis immediately prior to the

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[108] *See* Treas. Reg. § 1.731-2(j), Ex. (2).

[109] *See id.*

[110] *See id.* As this example shows, the amount of the deemed cash distribution is reduced substantially where the FLP distributes marketable securities with a low inside basis. Partners should therefore be reluctant to distribute freshly-purchased marketable securities with an inside basis (nearly) equal to their value. Likewise, marketable securities that have recently declined in value are less attractive candidates for distribution to donee-partners.

[111] I.R.C. §§ 704(c)(1)(B), 737, 731(c).

[112] Treas. Reg. § 1.731-2(g)(1)(i).

[113] *Id.*

[114] I.R.C. § 704(c)(1)(B).

[115] Treas. Reg. § 1.704-4(d)(2).

[116] *Id.* § 1.731-2(g)(1)(i).

[117] I.R.C. § 731(c)(1).

distribution.[118] Recall that while section 731(c) contains a return-to-sender exception, there is no authority for extending this exception to a contributing partner's assignee.[119]

Finally, one applies section 737,[120] in which a contributing partner recognizes built-in gain (not loss) from contributed property if the contributing partner receives a noncash asset in a distribution within seven years of the contribution.[121] Section 737 contains a return-to-sender exception, but as is the case under section 731(c), there is no express authority for allowing a contributing partner's assignee to claim this exception.[122]

II. A CASE STUDY IN THE PROBLEMS OF ASSIGNEES AND SUPER-RECOGNITION

Application of these three Code provisions can produce anomalous results. Perhaps the best way to understand these anomalies is through consideration of a fairly simple illustration.[123] This illustration will expose two significant and unnecessary problems that can arise when an FLP liquidates prematurely. Augustus, a wealthy individual, creates a limited liability company (LLC) in year one by transferring the following three assets to the LLC in exchange for all of the ownership interests in the entity:

Asset	Fair Market Value	Adjusted Basis
Artwork	$ 900,000	$ 1,200,000
Land (undeveloped)	$ 900,000	$ 600,000
Marketable Securities	$ 900,000	$ 300,000
	$ 2,700,000	$ 2,100,000

[118] *Id.* § 731(a)(1).

[119] *See supra* notes 99–100 and accompanying text.

[120] Treas. Reg. § 1.731-2(g)(1)(i).

[121] I.R.C. § 737 (a)–(b).

[122] *See supra* notes 99–100 and accompanying text.

[123] This example is loosely based on a similar set of examples appearing in Samuel A. Donaldson, *Liquidation of the Family Partnership: The Taming of the Shrewd*, 20 PRAC. TAX LAW. 47, 51–60 (2006).

Augustus recognizes no gain or loss upon this exchange.[124] Beginning in year two, Augustus transfers ownership interests in equal shares to his three daughters, April, May, and June. All of the transfers are gifts. Neither Augustus nor any of the daughters recognizes gain or loss from these transfers.[125] By the end of year five, the three daughters own all of the interests in the LLC, each with an equal share. For convenience, it will be assumed that the fair market values of the LLC's assets remain unchanged throughout this period[126] and that the assets have generated no

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[124] At this point, the limited liability company has a single owner: Augustus. According to Treasury, the entity would be "[d]isregarded as an entity separate from its owner" for federal tax purposes, Treas. Reg. § 301.7701-3(b)(1)(ii), meaning that the tax laws will treat Augustus as if he still owned the contributed assets directly. Any income from the assets would be taxed to Augustus as if the entity were a sole proprietorship. *Id.* § 301.7701-2(a). Because Augustus is still the deemed owner of the assets, no exchange has yet occurred for tax purposes.

[125] When Augustus first transfers ownership interests to his daughters, the limited liability company converts from a "disregarded entity," *see supra* note 124, to a partnership for federal tax purposes, *see* Treas. Reg. §§ 301.7701-3(b)(1)(i). The Service has held that where the single owner of a limited liability company sells a 50% interest in the entity to an unrelated person, the buyer is deemed to purchase a 50% interest in each of the entity's assets. Rev. Rul. 99-5, 1999-6 I.R.B. 434. The buyer and the seller are then deemed to have immediately contributed their respective shares of the assets to a partnership in exchange for their interests in the partnership. *Id.* In this example, Augustus has gifted interests in the limited liability company to his daughters—the interests were not sold. Consistent with the ruling, then, Augustus will most likely be seen giving his daughters a proportionate share of each of the limited liability company's three assets. *See id.* This deemed transaction will not be taxable to Augustus or the daughters. *See* I.R.C. § 102(a). The daughters will take the same basis in their proportionate shares of the assets that Augustus had in those assets. *See id.* § 1015(a). Augustus and the daughters would then be seen as contributing their respective shares of the assets to the entity in exchange for their interests in what the federal tax laws see as a partnership. *See* Treas. Reg. § 1.721-1(a) (as amended in 1996). These deemed exchanges would not give rise to the recognition of gain or loss. *See* I.R.C. § 721(a). Furthermore, each "partner's" basis in his or her partnership interest (outside basis, *supra* note 107) will be the same as his or her aggregate bases in the proportionate shares of assets contributed to the entity. *See id.* § 722. Not surprisingly, the entity's basis in the three assets (inside basis, *supra* note 107) ultimately will be the same as Augustus's original basis set forth in the fact pattern. *See id.* § 723.

[126] This is an unfortunate assumption, and not just because it is unrealistic. From an estate planning perspective, Augustus very much hopes that the assets appreciate in value following his gift transfers, for all of the post-gift appreciation will not subject Augustus to

(*continued*)

items of income, gain, loss, deduction, or credit during the time they have been held by the LLC.[127]

At the beginning of year six, the daughters—now the only owners of the LLC—decide to liquidate the entity. The daughters agree that April will take the artwork, May will take the land, and June will take the marketable securities. As a result, each owner effectively receives $900,000 in property in exchange for her one-third interest in the LLC.[128] Because each daughter's basis in her ownership interest is assumed to be $700,000,[129] each daughter realizes a $200,000 gain from the liquidation. The federal income tax question is how much of that gain each daughter must recognize (i.e., include in gross income). The analysis here is presented separately for each daughter.

A. Successors Don't Succeed: Liquidation Consequences to April

As far is April is concerned, section 704(c)(1)(B) will apply to the land distributed to May and to the marketable securities distributed to June.[130] From section 704(c)(1)(B)'s perspective, April (through her predecessor-in-interest, Augustus)[131] contributed a share of these assets to the LLC and watched the LLC distribute those interests to other "partners" within seven

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liability for federal gift tax, *see* I.R.C. § 2501(a) (LexisNexis 2006), and his estate will not face liability for federal estate tax on such appreciation, *see id.* § 2001(a) (2000).

[127] This assumption is much more realistic: the artwork likely does not generate income unless it is rented out for display; the land is undeveloped, so it generates no rents and is not depreciable to any extent because it is not subject to wear and tear or obsolescence, *see* I.R.C. § 167(a) (LexisNexis 2006); and the marketable securities may not generate any dividend income.

[128] *See supra* text accompanying note 125.

[129] *See supra* text accompanying note 125. A one-third interest in a total adjusted basis of $2,100,000 is equal to $700,000.

[130] *See* I.R.C. § 704(c)(1)(B) (2000).

[131] As discussed in *supra* note 125, April would in fact be considered the transferor of some small portion of each of the LLC's three assets when the entity converted from a disregarded entity to a partnership (i.e., when Augustus first gave interests in the LLC to his daughters). *See* Treas. Reg. § 1.704-4(d)(2). Ultimately, however, this has no meaningful effect on the income tax consequences to April or the other daughters. This is because I.R.C. section 704(c)(1)(B) will apply equally to April in both of her capacities (as the direct contributing partner and as the assignee of a contributing partner). *See* I.R.C. § 704(c)(1)(B); Treas. Reg. § 1.704-4(d)(2). Consequently, the daughters' deemed contributions to the LLC are ignored throughout the balance of the I.R.C. section 704(c)(1)(B) analysis.

years of contribution.[132] Section 704(c)(1)(B) does not apply to the artwork April receives because the return-to-sender exception that would apply to Augustus if he got back the artwork he contributed applies to April as Augustus's successor-in-interest.[133] If the LLC sold the land for its fair market value, the LLC would recognize a $300,000 gain.[134] As a one-third owner (and a one-third successor to Augustus's interest), April's share of that gain would be $100,000. Accordingly, April must recognize a $100,000 gain from the distribution of the land to May.[135] With respect to the marketable securities, the LLC would recognize a $300,000 loss if it sold the securities.[136] April's share of that loss would be $100,000. Because section 704(c)(1)(B) applies not only to realized gains but also to realized losses, April recognizes this loss from the distribution of the marketable securities to June.[137] Thus, April recognizes both a $100,000 gain and a $100,000 loss under section 704(c)(1)(B). To the extent these items have the same characterization,[138] the items offset, meaning April effectively recognizes no net gain or loss under section 704(c)(1)(B).[139] Likewise, the application of section 704(c)(1)(B) to April ultimately has no effect on her outside basis.[140] Formally, her outside basis is increased by the $100,000 gain and decreased by the $100,000 loss.[141] But this simply keeps her outside basis at $700,000.

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[132] *See* I.R.C. § 704(c)(1)(B).

[133] *See* Treas. Reg. § 1.704-4(d)(2).

[134] The amount realized by the LLC would be $900,000, *see* I.R.C. § 1001(b); and its inside basis in the land is $600,000, yielding a $300,000 realized gain, *see id.* § 1001(a).

[135] *See id.* § 704(c)(1)(B)(i). On these facts, the character of that gain is likely long-term capital gain. *See id.* §§ 1221(a), 1222(3). The land appears to be a capital asset in the hands of the LLC. *See id.* § 1221(a). Because the LLC held the land for more than one year, the resulting gain would thus be long-term capital gain. *See id.* § 1222(3). Accordingly, the gain to April will be treated as long-term capital gain. *See id.* § 704(c)(1)(B)(ii).

[136] Here, the amount realized would be $900,000, *see id.* § 1001(b), but the inside basis of the stock is $1,200,000, *see id.* § 1001(a).

[137] *See id.* § 704(c)(1)(B)(i). This loss would pass through as long-term capital loss because the securities are capital assets in the LLC's hands on these facts. *See id.* §§ 704(c)(1)(B)(ii), 1221(a), 1222(4).

[138] *See supra* notes 135–37 and accompanying text.

[139] *See* I.R.C. § 704(c)(1)(B)(i)–(ii).

[140] *See id.* § 704(c)(1)(B)(iii).

[141] *See id.*; Treas. Reg. § 1.704-4(e)(1) (as amended in 2005).

The next step is to apply section 731(c),[142] the rule that treats marketable securities as cash.[143] Because April does not receive any of the marketable securities, section 731(c) does not apply to her.[144]

Finally, one comes to the vexing problem of section 737.[145] The section requires April to recognize the lesser of the "excess distribution" amount and the "net precontribution gain" amount.[146] The excess distribution amount is determined by subtracting her "reduced outside basis" from the value of the property received in the distribution.[147] April's reduced outside basis is her outside basis after the application of sections 704(c)(1)(B) and 731(c), reduced by any cash received in the same transaction.[148] Because April receives no cash in the liquidation and because neither section 704(c)(1)(B) nor section 731(c) affects her outside basis,[149] April's reduced outside basis is the same $700,000 she had immediately prior to the liquidation.[150] The artwork, worth $900,000, exceeds this reduced outside basis by $200,000; and thus, the excess distribution amount is $200,000.

The "net precontribution gain" amount is simply April's share of the gain to the LLC had it sold the artwork instead of distributing it to her.[151] Had the LLC sold the artwork, its gain would have been $600,000,[152] and April's share of that gain would have been $200,000. The net precontribution gain amount thus equals the excess distribution amount, meaning April seemingly must recognize a $200,000 gain under section 737.[153]

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[142] Treas. Reg. § 1.731-2(g)(1)(i).

[143] I.R.C. § 731(c)(1)(A).

[144] *See id.* § 731(a).

[145] Treas. Reg. § 1.731-2(g)(1)(i).

[146] *See* I.R.C. § 737(a).

[147] *See id.* § 737(a)(1); Treas. Reg. § 1.737-1(b)(3) (1995).

[148] *See* Treas. Reg. § 1.737-1(b)(3). The regulation uses the term "adjusted tax basis" instead of "reduced outside basis." *Id.* The latter term is used in this article under the belief it is at once more descriptive of the concept and less likely to be confused with the general concept of "adjusted basis" under I.R.C. section 1016 (Supp. I 2001).

[149] *See supra* notes 140, 144 and accompanying text.

[150] *See supra* note 129 and accompanying text.

[151] *See* I.R.C. § 737(b); *supra* note 70 and accompanying text.

[152] The amount realized would be $900,000 and the inside basis is $300,000, so the sale would generate a $600,000 realized gain. *See* I.R.C. § 1001(a)–(b).

[153] *See id.* § 737(a).

After applying all of the relevant statutory provisions, April recognizes a net $200,000 gain.[154]

Figure 3 summarizes the consequences to April.

Figure 3: Consequences to April

(1) Section 704(c)(1)(B):

* Land (distributed to May) →

If LLC sold the asset for FMV, there would be $300,000 of gain to LLC.

April's share of that gain would be **$100,000**.

* Marketable securities (distributed to June) →

If LLC sold the asset for FMV, there would be $300,000 of loss to LLC.

April's share of that loss would be **($100,000)**.

*April thus recognizes a **$100,000 gain** and a **($100,000) loss** under section 704(c)(1)(B).*

(2) Section 731(c): → does not apply because April received no marketable securities

(3) Section 737:

* Artwork (received by April) →

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	900,000	If LLC sold the asset for FMV
- reduced OB	(700,000)	there would be $600,000 of gain to
ED	***200,000***	LLC, ***$200,000*** allocable to April

*Therefore, April likely recognizes a total **$200,000 gain** under section 737.*

April's basis in the artwork will be $900,000.[155] Specifically, April's basis in the artwork is her outside basis immediately prior to the distribution ($700,000) plus the gain recognized under section 704(c)(1)(B) ($100,000), minus the loss recognized under section

[154] *See id.* §§ 704(c)(1)(B), 731(c), 737, 1001(a).

[155] *See id.* § 732(b).

704(c)(1)(B) ($100,000), plus her gain recognized under section 737 ($200,000).[156] If April sells the artwork the next day for its fair market value ($900,000), she will recognize no further gain or loss.[157] This is fitting since she has already recognized the difference between the $900,000 received in the liquidation and her preliquidation outside basis ($700,000). So, perhaps this result looks fair.

But it is not. Had the artwork been distributed to the original contributing partner, Augustus, section 737 would not apply at all because of the return-to-sender exception.[158] As previously explained, there is no express authority that permits April to claim this exception as Augustus's successor,[159] although some commentators take the position that April can claim this exception.[160]

Recall that the regulations under section 704(c)(1)(B) expressly provide that an assignee is eligible for the return-to-sender exception with respect to property contributed to the partnership by the assignor.[161] The regulations under section 737, however, are entirely silent on the matter—they neither expressly extend the exception to assignees nor expressly

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[156] *See* Treas. Reg. §§ 1.704-4(e)(1) (as amended in 2005), 1.737-3(b)(1) (as amended in 1996).

[157] *See* I.R.C. § 1001(a)–(c).

[158] *See id.* § 737(d)(1).

[159] *See supra* notes 76–77 and accompanying text.

[160] *See* Harrison & Blum, *supra* note 78, at 315; Mark P. Gergen, *Potential Tax Traps in Liquidating a Family Limited Partnership*, 101 TAX NOTES 1431, 1433 n.10 (2003).

[161] Treas. Reg. § 1.704-4(d)(2). It warrants mention that the regulations under section 704(c)(1)(B) are "legislative regulations" that merit even more deference from courts than ordinary "interpretive regulations." I.R.C. § 704(c)(1) (providing the secretary with authority to promulgate regulations under this section); Fife v. Comm'r, 82 T.C. 1, 15 (1984) (citing Zoltan v. Comm'r, 79 T.C. 490, 495 n.11 (1982)); GAIL LEVIN RICHMOND, FEDERAL TAX RESEARCH 131 (6th ed. 1990) ("[T]he degree of deference accorded legislative regulations is higher than that accorded interpretive regulations."). Even though Treasury had no statutory basis for extending the return-to-sender exception to assignees, Congress's delegation of authority here would lead most courts to conclude that the regulations are an appropriate interpretation of the law. *See, e.g.*, Rowan Cos., Inc. v. United States, 452 U.S. 247, 253 (1981) ("Where the Commissioner acts under specific authority, our primary inquiry is whether the interpretation or method is within the delegation of authority."); Nat'l Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979) ("[R]elevant considerations [of Congressional intent] are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute." (citations omitted)).

disqualify assignees from claiming the exception.[162] What are we to make of this silence?

It could mean any of three things.[163] First, it could mean that Treasury intends that the exception not be applied to assignees. As one commentator observed in this context, "Silence can be meaningful."[164] This is a sensible conclusion, especially in light of the fact that assignees are expressly mentioned elsewhere in the section 737 regulations.[165] As a general matter of statutory interpretation, this is the safest conclusion.

Second, regulatory silence under section 737 could mean that Treasury finds it redundant to expressly extend the return-to-sender exception to assignees because it is already apparent that an assignee steps into the shoes of an assignor for such purposes. This is consistent with the Uniform Limited Partnership Act, which generally provides that an assignee (transferee) steps into the shoes of the assignor (transferor) with respect to distributions and rights at liquidation.[166] The transferee also assumes all obligations to the partnership owed by the transferor.[167] Yet, a transferee does not fully assume the identity of the transferor for all purposes under the Uniform Limited Partnership Act.[168] As the drafters succinctly state, "[A] transferee has no right to participate in management in any way, no voting rights and, except following dissolution, no information rights. Even after dissolution, a transferee's information rights are limited."[169] Because the assignee of a partner sometimes steps into the assignor's shoes and sometimes does not,[170] Treasury's silence in the section 737 regulations should not be taken to mean that the result would be obvious one way or the other.

Finally, Treasury's silence could mean that Treasury did not consider the issue at all. If this is the case, there is an open door for arguing that the return-to-sender exception should apply to assignees. A leading treatise on partnership taxation concludes that the exception should apply to assignees, though it acknowledges that the regulations do not clearly

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[162] *See* Treas. Reg. §§ 1.737-1 to 1.737-5.

[163] *See* Burns v. United States, 501 U.S. 129, 136 (1991) (describing similar inferences regarding congressional silence in statutes).

[164] Gergen, *supra* note 160, at 1433.

[165] *E.g.*,Treas. Reg. §§ 1.737-1(c)(2)(iii), 1.737-2(b)(2).

[166] UNIF. LTD. P'SHIP ACT § 702(b)(1) (2001).

[167] *Id.* § 702(g).

[168] *Id.* § 702(a)(3).

[169] *Id.* § 704, cmt.

[170] *See supra* note 165 and accompanying text.

support this conclusion: "The step-in-the-shoes rule should apply to all aspects of §737 (e.g., the exception for distributions of previously contributed property provided by Reg. §1.737-2(d)), although the regulation by its terms is more limited."[171] The treatise does not explain why the return-to-sender exception should be extended to assignees,[172] but one can deduce what the authors were likely thinking.

For one thing, Congress intended section 737 to complement section 704(c)(1)(B).[173] The two provisions, in concert, deter the use of partnerships to effect tax-free exchanges of built-in gain property.[174] Without section 737, a partner could easily contribute built-in gain property to the partnership and receive back from the partnership some noncash, nonlike-kind property without recognizing gain.[175] Section 704(c)(1)(B) would be powerless to stop this abuse unless the partnership distributed the built-in gain property to another partner within seven years of its contribution.[176] If section 737 is intended to buttress section 704(c)(1)(B), the return-to-sender exception must logically extend to assignees of a contributing partner. The chain of reasoning is compelling, as Figure 4 illustrates.

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[171] MCKEE, NELSON & WHITMIRE, *supra* note 7, at 19-44 to 19-45 n.153.

[172] *Id.* at 19-45.

[173] *Cf.* 102 H.R. Rep. No. 102-1018, at 428–29 (1992), *reprinted in* 1992 U.S.C.C.A.N. 2519. Rpt. 1018 at Title XIX(B), *available at* LEXIS, LEXSEE Service, 102 H. Rpt. 1018. In explaining how pre-I.R.C. section 737 law worked, the legislative history observed that I.R.C. section 704(c)(1)(B) by itself was easy to avoid:

> If property contributed to a partnership by a partner is subsequently distributed to another partner within 5 years of the contribution, the contributing partner generally recognizes gain as if the property had been sold for its fair market value at the time of the distribution. Present law generally does not require a partner who contributes appreciated property to a partnership to recognize pre-contribution gain upon a subsequent distribution of other property to that partner even if the value of that other property exceeds the partner's basis in his partnership interest.

Id. By enacting I.R.C. section 737(a), then, Congress intended to preclude the easy avoidance of I.R.C. section 704(c)(1)(B).

[174] Gergen, *supra* note 160, at 1432.

[175] I.R.C. § 737(a) (2000).

[176] *See id.* § 704(c)(1)(B).

Figure 4: The Return-to-Sender Exception Logically Applies to Assignees

- **The general rule of section 704(c)(1)(B)**, that a contributing partner recognizes gain upon the partnership's distribution of contributed built-in gain property to another partner within seven years of contribution, **applies to the contributing partner's assignee**.
- **The return-to-sender exception in section 704(c)(1)(B)**, whereby a contributing partner does not recognize gain upon the partnership's distribution of contributed built-in gain property back to the contributing partner, **also applies to the contributing partner's assignee**.
- **The general rule of section 737(a)**, that a contributing partner recognizes gain upon the partnership's distribution of noncash property to the contributing partner within seven years of contribution, **applies to the contributing partner's assignee**.
- **Section 737(a)** is intended to complement section 704(c)(1)(B).
- Therefore, **the return-to-sender exception in section 737**, whereby a contributing partner does not recognize gain upon the partnership's distribution of contributed built-in gain property back to the contributing partner, **should also apply to the contributing partner's assignee**.

Not everyone is persuaded. Professor Gergen observed:

> While section 737 is adjunct to section 704(c), the two provisions address different situations. Section 704(c) generally identifies to whom will be allocated precontribution gain or loss realized by a partnership on disposition of an asset bearing that gain or loss. Section 737 speaks to whether a partner who receives property in a

> distribution with a value in excess of his basis in his partnership interest should recognize gain.[177]

It is true that section 704(c) generally applies to sales[178] and section 737 applies to distributions.[179] But section 704(c)(1)(B) specifically targets sales in the form of distributions.[180] Thus, the rules are very much related—they both threaten recognition of gain by a contributing partner where the partnership distributes property within seven years of the contribution of built-in gain property.[181] As previously explained, sections 704(c)(1)(B) and 737 are symbiotic.[182] Either provision by itself would be easy to avoid; together they provide a more complete deterrent to the disguised sale problem. Given the close connection of these rules, one cannot so casually dismiss analogies to the regulations under section 704(c)(1)(B) when interpreting the regulations under section 737.

Professor Gergen continued:

> Global application of the contributed property exception to transferees creates several problems. While these problems are fairly technical in nature, they do suggest that had Treasury meant the exception to apply to transferees, it would have said so and addressed the implications. . . . Section 737 may not have been forged as a weapon to wield in the war against family limited partnerships, but it is nicely adaptable to that use. Rely on the exception at your peril.[183]

This suggests there are many technical glitches, either in the Code or the regulations, that would make extension of the return-to-sender exception prohibitively complex or manifestly undesirable. Upon closer scrutiny, however, it is hard to ascertain what those glitches may be. Professor Gergen discussed only one of the "several problems" in a footnote:

> The most serious problems involve integrating the handling of the transferee in a carryover basis transaction

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[177] Gergen, *supra* note 160, at 1433.
[178] I.R.C. § 704(c)(1)(B)(i).
[179] *Id.* § 737(a).
[180] *See id.* § 704(c)(1)(B)(i).
[181] *Id.* §§ 704(c)(1)(B); 737(b)(1).
[182] *See supra* notes 173–74 and accompanying text.
[183] Gergen, *supra* 160, at 1433 (internal citation omitted).

> (e.g., a contribution of a partnership interest to a partnership or to a controlled corporation) with regulation sections 1.737-2(b) and -2(c). If I were at Treasury, I would be reluctant to extend the contributed property exception to transferees globally until I had worked out the ramifications for tax-free transfers of partnership interests.[184]

Integration in this context does not appear to be all that difficult. One of the regulations cited in the footnote states that section 737 does not apply when the partnership (transferor partnership) transfers its assets to another partnership (transferee partnership) in a tax-free formation under section 721 and then distributes the interests in the transferee partnership to the partners in liquidation of the transferor partnership.[185] That same regulation refers to "a similar rule in the context of section 704(c)(1)(B)."[186] So even though the section 704(c)(1)(B) regulations extend the return-to-sender exception to assignees,[187] they still contain a similar rule with respect to carryover basis transactions. Apparently, the problems of carryover basis are not as significant as one might think.

The other regulation cited in the footnote states a similar rule: section 737 does not apply when the partnership transfers its assets to a corporation in a tax-free formation under section 351 and then distributes the stock in the corporation to the partners in liquidation of the transferor partnership.[188] Here, too, the regulation refers to "a similar rule in the context of section 704(c)(1)(B)."[189] Once again, Treasury had no problems extending the return-to-sender exception to assignees "globally" under section 704(c)(1)(B) even though the regulations also contained these special rules for carryover basis transactions.

If meshing the extension of the return-to-sender exception to assignees with carryover basis transactions is so fraught with uncertainty, it is doubtful Treasury would have extended the exception for purposes of section 704(c)(1)(B). Yet Treasury did so with no apparent hesitation. There seem to be no discernible technical difficulties with extending the return-to-sender exception to assignees under section 737. Moreover, there

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[184] *Id.* at 1433 n.12.

[185] Treas. Reg. § 1.737-2(b)(1) (as amended in 2005).

[186] *Id.* (citing Treas. Reg. § 1.704-4(c)(4)).

[187] *Id.* § 1.704-4(d)(2).

[188] *Id.* § 1.737-2(c); I.R.C. § 351(a) (2000).

[189] Treas. Reg. § 1.737-2(c) (citing Treas. Reg. § 1.704-4(c)(5)).

is no tax policy justification for declaring that assignees fully step into their assignors' shoes under section 704(c)(1)(B)[190] but do not fully step into their shoes for purposes of section 737. Therefore, the return-to-sender exception in section 737 should be extended to assignees. The case for extension of the exception is buttressed in Part B in the context of the liquidation consequences to May.

B. Déjà Vu All Over Again: Liquidation Consequences to May

Fortunately for the reader but unfortunately for May, the results here are similar to those for April. Section 704(c)(1)(B) applies to the artwork distributed to April and to the marketable securities distributed to June.[191] Section 704(c)(1)(B) does not apply to the land May receives because the return-to-sender exception that would protect Augustus from taxation if he received the land in a distribution applies to May as Augustus's successor-in-interest.[192] If the LLC sold the artwork for its fair market value, the LLC would recognize a $600,000 gain.[193] Accordingly, May recognizes a $200,000 gain from the distribution of the artwork to April.[194] With respect to the marketable securities, the LLC would recognize a $300,000 loss if it were sold (as shown in the analysis for April).[195] May's share of that loss would be $100,000, and this amount too is recognized.[196] Thus, May recognizes a $200,000 gain and a $100,000 loss under section 704(c)(1)(B). This would increase May's outside basis to $800,000 ($700,000 plus the $200,000 gain recognized under section 704(c)(1)(B) minus the $100,000 loss under section 704(c)(1)(B)).[197]

Because May does not receive any portion of the marketable securities in the liquidation, section 731(c) does not apply to her.[198] My junior high English teacher told me to avoid one-sentence paragraphs, so now this paragraph has three sentences. The last two are not relevant, but at least my teacher should be pleased.

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[190] *Id.* § 1.704-4(d)(2).

[191] *See* I.R.C. § 704(c)(1)(B).

[192] *See id.*; Treas. Reg. § 1.704-4(d)(2).

[193] The amount realized would be $900,000 and the inside basis is $300,000, so there would be a $600,000 realized gain. *See* I.R.C. § 1001(a)–(b).

[194] *See id.* § 704(c)(1)(B)(i).

[195] *See supra* notes 136–37 and accompanying text.

[196] *See* I.R.C. § 704(c)(1)(B)(i).

[197] *See id.* § 704(c)(1)(B)(iii); Treas. Reg. § 1.704-4(e)(1).

[198] *See* I.R.C. § 731(c)(1)(A).

Finally comes section 737. Here, May must recognize the lesser of the excess distribution amount and the net precontribution gain.[199] The excess distribution amount in turn requires a determination of May's "reduced outside basis," meaning her outside basis after the application of sections 704(c)(1)(B) and 731(c), reduced by any cash received in the same transaction.[200] Because May received no cash in the liquidation, May's reduced outside basis would be the $800,000 computed in the preceding paragraph. The land, worth $900,000, exceeds this reduced outside basis by $100,000, so the excess distribution amount is $100,000.[201] The "net precontribution gain" amount is likewise $100,000, for that would be May's share of the gain to the LLC had it sold the land instead of distributing it to her.[202] Therefore, May must likely recognize $100,000 of gain under section 737.

Combined with the $100,000 of net gain recognized under section 704(c)(1)(B),[203] this means May, like April, will recognize as gross income the full $200,000 difference between the value of the property received at liquidation ($900,000) and her outside basis immediately prior to liquidation ($700,000).[204]

Figure 5 summarizes this result.

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[199] *See id.* § 737(a).

[200] *See id.* § 737(a)(1).

[201] *See id.*

[202] *See id.* § 737(b). Had the LLC sold the land, its gain would have been $300,000 (as computed in the analysis for April, *supra* note 134 and accompanying text), and May's share of that gain would have been $100,000.

[203] *See supra* notes 191–97 and accompanying text.

[204] *See supra* notes 128–29 and accompanying text.

Figure 5: Consequences to May

(1) Section 704(c)(1)(B):
* Artwork (distributed to April) →
If LLC sold the asset for FMV, there would be $600,000 of gain to LLC.

May's share of that gain would be **$200,000**.

* Marketable securities (distributed to June) →
If LLC sold the asset for FMV, there would be $300,000 of loss to LLC.

May's share of that loss would be **($100,000)**.

*May thus recognizes a **$200,000 gain** and a **($100,000) loss** under section 704(c)(1)(B).*

(2) Section 731(c): → does not apply because May received no marketable securities

(3) Section 737:
* Land (received by May) →

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib. Gain
FMV	900,000	If LLC sold the asset for FMV
- reduced OB	(800,000)	there would be $300,000 of gain to
ED	***100,000***	LLC, ***$100,000*** allocable to May

*Therefore, May likely recognizes a total **$100,000 gain** under section 737.*

Under section 732(b), May's basis in the land will be $900,000.[205] Specifically, her basis in the land is her outside basis immediately prior to the distribution ($700,000) plus the gain recognized under section 704(c)(1)(B) ($200,000), minus the loss recognized under section 704(c)(1)(B) ($100,000), plus her gain recognized under section 737 ($100,000).[206] If she sells the land the next day for its fair market value

[205] *See* I.R.C. § 732(b).

[206] *See* Treas. Reg. §§ 1.704-4(e)(1) (as amended in 2005), 1.737-3(b)(1) (as amended in 1996).

($900,000), May will recognize no further gain or loss, again because the $200,000 difference between the $900,000 May receives in the liquidation and her $700,000 preliquidation outside basis is recognized upon liquidation.[207]

May suffers the same injustice as April. As Professor Hausman observed:

> Because partnership interests are frequently transferred by gift, the need for clarification of these regulations is significant. It seems that the same rules should apply to both sections 704(c)(1)(B) and 737 insofar as the Original Contributor Exception is concerned. There does not seem to be a policy reason for having different rules for these two sections.[208]

Treasury should follow Professor Hausman's suggestion and make the rules uniform. Treasury could achieve uniformity either by restricting the return-to-sender exception in section 704(c)(1)(B) so as to exclude assignees or it could extend the return-to-sender exception in section 737 to include assignees. As between these options, the latter is more consistent with the general tax perspective that an assignee completely steps into the assignor's shoes. Beneficial assignees generally take their assignor's basis[209] and holding period[210] in the assigned property, and beneficial assignees can be liable for payment of tax normally attributable to the assignor.[211] These rules reflect a clear preference for having a beneficial assignee step completely into the shoes of the assignor for federal tax purposes. Accordingly, the return-to-sender exception should be extended to the sender's assignees.

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[207] *See* Figure 5: Consequences to May.

[208] Thomas I. Hausman, *Mixing Bowls and Marketable Securities in a Family Limited Partnership*, 101 TAX NOTES 373, 383 (2003).

[209] *See* I.R.C. § 1015(a) ("If the property was acquired by gift . . . the basis shall be the same as it would be in the hands of the donor . . . except . . . for the purpose of determining loss . . . .").

[210] *See id.* § 1223(2) (stating the taxpayer may tack another taxpayer's holding period in the same property where the taxpayer's basis is the same as the other taxpayer's basis).

[211] *See id.* § 6901(a) (stating the Service may assert transferee liability against beneficial assignees who are secondarily liable for donor's income or gift tax liability).

C. The Risk of Super-Recognition: Liquidation Consequences to June

Like her sisters, June will recognize gain under section 704(c)(1)(B). June will have to recognize $200,000 of gain from the distribution of the artwork to April, as was the case for May.[212] And just like April, June will recognize a $100,000 gain from the distribution of the land to May.[213] Altogether then, June recognizes $300,000 of gain under section 704(c)(1)(B),[214] an odd result considering the difference between the value of the property received by June in the liquidation ($900,000) is only $200,000 more than her outside basis immediately prior to liquidation ($700,000).[215] More on that later; for now, note that the total $300,000 gain will be added to June's outside basis, raising it to an even $1 million.[216]

Section 731(c) will treat June's receipt of the $900,000 in marketable securities as the receipt of cash.[217] Because the stock is loss property, there is no "gain portion" to carve out from the value of the shares.[218] Accordingly, the full $900,000 in value will be treated as cash.[219] The distribution will not be taxable, however, because of the fresh $1 million basis that June can apply against the distribution.[220] In fact, June has $100,000 of outside basis left even after applying section 731(c).[221]

Section 737 does not apply to June at all because the entire value of the marketable securities was treated as a deemed cash distribution under section 731(c).[222] This makes sense because there is no "net precontribution gain" on this loss property, meaning the "lesser of" amount for purposes of section 737(a) would necessarily be zero.[223] The results for June are summarized in Figure 6.

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[212] *See supra* notes 191–97 and accompanying text.
[213] *See supra* notes 134–35 and accompanying text.
[214] *See* I.R.C. § 704(c)(1)(B).
[215] *See supra* text accompanying note 125.
[216] *See* I.R.C. § 704(c)(1)(B)(iii); Treas. Reg. § 1.704-4(e)(1).
[217] *See* I.R.C. § 731(c)(1).
[218] *See supra* notes 105–10 and accompanying text.
[219] *See* I.R.C. § 731(a), (c)(1).
[220] *See id.* § 731(a)(1).
[221] *See id.*
[222] *See* Treas. Reg. § 1.731-2(g)(1)(iii)(A).
[223] *See* I.R.C. § 737(a)–(b).

Figure 6: Consequences to June

(1) Section 704(c)(1)(B):

* Artwork (distributed to April) →

If LLC sold the asset for FMV, there would be $600,000 of gain to LLC.

June's share of that gain would be **$200,000**.

* Land (distributed to May) →

If LLC sold the asset for FMV, there would be $300,000 of gain to LLC.

June's share of that gain would be **$100,000**.

*June thus recognizes a **$300,000 gain** under section 704(c)(1)(B).*

(2) Section 731(c): → Marketable Securities

Fair Market Value:	$900,000
less Share of Net Gain:	
If LLC sold for FMV, no gain →	(0)
Deemed Cash Distribution:	***$900,000***
Beginning Outside Basis:	700,000
704(c)(1)(B) Gain:	300,000
Precash Outside Basis	1,000,000
[see Treas. Reg. § 1.731-2(g)(1)(ii)]	
731(c) Cash	***(900,000)***
Remaining Outside Basis:	100,000

*So June recognizes **no gain** under section 731(c).*

(3) Section 737: → does not apply because entire distribution was treated as cash under section 731(c) [Treas. Reg. § 1.731-2(g)(1)(iii)(A)]

The numbers prove this to be true anyway:

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	0	If LLC sold the asset for FMV there
- reduced OB	(100,000)	would be no gain to LLC
ED	***0***	

*Therefore, June likely recognizes **no gain** under section 737.*

But June is left with $100,000 of unused outside basis. One might think that June could deduct this amount as a loss under section 731(a)(2) because June received a deemed distribution of cash from the partnership in liquidation of her interest. Unfortunately, this is not the case. Section 731(c)(1) expressly provides that June's receipt of the United stock is treated as cash *only* for purposes of sections 731(a)(1) and 737.[224] June's stock is not treated as cash for purposes of section 731(a)(2), so she cannot claim the loss.[225] Instead, the loss will be preserved in her basis in the marketable securities.[226] June's basis in the United stock will be $1 million.[227] If she later sells the stock for its fair market value at liquidation ($900,000) she can finally recognize the $100,000 loss.[228]

In effect, the $200,000 difference between the value of the marketable securities distributed to June and her preliquidation outside basis is accounted for in the harshest of ways: she must recognize $300,000 of gain first and then sell the distributed property to claim what hopefully proves to be an offsetting $100,000 loss.[229] We can use the term "super-recognition" to refer to situations like this where a taxpayer must recognize more gain than the taxpayer would realize upon an outright sale. Had June simply sold her ownership interest in the LLC at its liquidation value ($900,000, representing her share of the LLC's net equity in its assets), she would realize and recognize a $200,000 gain.[230] But because she received loss property in the liquidation of the LLC, she suffers super-recognition with an offsetting deferred loss.[231]

June will likely be upset. From her perspective, June's gain is $200,000—she receives marketable securities worth $900,000 and her outside basis immediately prior to liquidation was $700,000. How can it be that June recognizes $300,000 of gain upon liquidation of LLC when her realized gain from the sale of her partnership interest would only be $200,000? This result could not occur under section 737 because the statute limits the amount of gain recognized so that it can never exceed the difference between the value of the property received and the recipient

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[224] *See id.* § 731(c)(1).

[225] *See id.* § 731(a)(2).

[226] *See id.* § 732(b).

[227] *See id.* The basis in the marketable securities equals the $700,000 original outside basis plus the $300,000 total gain under section 704(c)(1)(B). *See supra* note 216.

[228] *See* I.R.C. § 1001(a)–(c).

[229] *See supra* notes 214, 226–28 and accompanying text.

[230] *See* I.R.C. § 1001(a)–(c).

[231] *See supra* notes 224–28 and accompanying text.

partner's outside basis immediately prior to the liquidation.[232] Yet section 704(c)(1)(B) contains no similar limitation, and it therefore follows that super-recognition results.[233]

As counterintuitive as super-recognition appears, however, the result is correct. Section 704(c)(1)(B) treats the distributions to April and May as sales by the LLC of the artwork and land.[234] Had the LLC in fact sold those assets to unrelated third parties before liquidation, June would still have to recognize a total of $300,000 in gain (her share of the built-in gain on each of the assets).[235] The $300,000 recognized gain would then increase June's outside basis to $1 million.[236] A subsequent distribution of the $900,000 in marketable securities to June in liquidation of her interest would not be taxable because her outside basis exceeds the value of the distributed stocks.[237] Furthermore, June would take a $1 million basis in the distributed securities, preserving a $100,000 loss for June's subsequent disposition of the marketable securities in a taxable transaction.[238] This is the same result that occurs upon liquidation of the LLC.[239] The results to June under the liquidation are thus identical to the results that would occur if the LLC sold the assets distributed to April and May and then distributed the marketable securities to June in liquidation of her interest.

The problem, therefore, lies not in section 704(c)(1)(B)'s failure to limit the recognized gain to the net unrealized gain lurking in the partnership interest, but in the decision to allocate gain and loss properties

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[232] *See* I.R.C. § 737(a)(1). More technically, the recognized gain under section 737 cannot exceed the excess of the fair market value of noncash property received in the liquidation over the partner's reduced outside basis. *Id.* See *supra* note 148 and accompanying text for an explanation of the concept of "reduced outside basis."

[233] *Compare* I.R.C. § 737(a)(1), *with id.* § 704(c)(1)(B).

[234] *See id.* § 704(c)(1)(B)(i).

[235] *See id.* § 704(c)(1)(A). The $600,000 gain from the disposition of the artwork would be allocated equally among the daughters, as they are each one-third successors to Augustus's interest in the LLC. *Id.* The same result occurs with respect to the $300,000 gain from the disposition of the land. *Id.* Accordingly, each daughter would recognize a $200,000 gain from the LLC's sale of the artwork and a $100,000 gain from the LLC's sale of the land. *Id.*

[236] *See id.* § 705(a)(1)(A).

[237] *See supra* notes 54–55 and accompanying text.

[238] *See* I.R.C. § 732(b). Under this section, June's basis would be $1 million and, upon sale of the marketable securities for their fair market value of $900,000, she will recognize a $100,000 loss. *Id.*

[239] *See supra* notes 224–28 and accompanying text.

differently. Compare the aforementioned liquidation consequences with the results of a pro rata liquidation, one where the daughters each take an undivided one-third interest in each of the LLC's three assets. Because each daughter would be receiving property proportionate to her shares of Augustus's unrealized gain and loss at contribution, Treasury takes the position that no deemed sale of the assets occurs.[240] Consequently, no daughter would recognize gain or loss under section 704(c)(1)(B).[241]

A proportionate liquidation would also yield no tax liability under section 731(c).[242] Section 731(c) would treat the $900,000 in marketable securities as cash, meaning each daughter would receive a deemed cash distribution of $300,000.[243] Each daughter would still have an outside basis of $700,000, so the deemed cash distribution would not be taxable.[244] The distribution would serve to reduce each daughter's outside basis from $700,000 to $400,000.[245]

Finally, one would apply section 737. Assuming the return-to-sender exception does not apply to the daughters as Augustus's transferees, section 737(a) would cause each daughter to recognize the $200,000 difference between the value of her share of LLC's assets and her original outside basis.[246] Appropriately, each daughter's aggregate basis in her shares of the various assets would be $900,000: the original $700,000 of

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[240] *See supra* notes 66–68 and accompanying text.

[241] *See* Treas. Reg. § 1.704-4(c)(6) (as amended in 2005).

[242] Recall that section 731(c) is applied after section 704(c)(1)(B). Treas. Reg. § 1.731-2(g)(1)(i).

[243] *See* I.R.C. § 731(c)(1)(B). The limitation in section 731(c)(3)(B), *see supra* notes 103–10 and accompanying text, would have no effect here because that limitation only reduces the amount of the deemed cash distribution by the recipient partners' shares of the net *gain* in the distributed securities. I.R.C. § 731(c)(3)(B). Because the securities here are loss property, the limitation is irrelevant.

[244] *See id.* § 731(a)(1) (stating gain is only recognized if the money distributed exceeds the partner's basis prior to distribution).

[245] *See id.* § 732(b).

[246] *See id.* § 737(a). The formal calculations work as follows: the I.R.C. section 737(a)(1) amount for each daughter is $500,000, the excess of the fair market value of the property received ($900,000, or one-third of the value of all LLC assets) over her reduced outside basis ($400,000, thanks to the deemed cash distribution under I.R.C. section 731(c)); the I.R.C. section 737(a)(2) amount for each daughter is $200,000 (one-third of the $600,000 net built-in gain from Augustus's contributions). The amount of gain recognized is the lesser of these two amounts, so each daughter recognizes $200,000 of gain. *See id.*

outside basis plus the $200,000 gain recognized under section 737(a).[247] Thus, each daughter's aggregate basis would equal the liquidation value of the assets she receives in the proportionate liquidation. Notice that super-recognition is not a problem when the partners effect a pro rata distribution of an FLP's gain and loss assets at liquidation.[248]

Figure 7 offers a thumbnail comparison of the non-pro rata liquidation with the results of the pro rata liquidation.

Figure 7: Comparison of Non-Pro Rata and Pro Rata Liquidations

Non-pro rata liquidation

Partner	Receives	Recognized Gain (Loss)	Deferred Gain (Loss)
April	100% artwork	$ 100,000 gain under § 704(c)(1)(B) ($100,000) loss under § 704(c)(1)(B) $ 200,000 gain under § 737 **$ 200,000 net gain**	None
May	100% land	$ 200,000 gain under § 704(c)(1)(B) ($100,000) loss under § 704(c)(1)(B) $ 100,000 gain under § 737 **$ 200,000 net gain**	None
June	100% marketable securities	$ 300,000 gain under § 704(c)(1)(B) **$ 300,000 net gain**	**($100,000) deferred loss**

[247] *See* Treas. Reg. § 1.737-3(b)(1). The deemed cash distribution to each daughter under I.R.C. section 731(c) does not come into play in computing the daughter's basis in the distributed assets. Although I.R.C. section 732(b) adjusts basis for "money distributed" in the liquidating distribution, I.R.C. section 731(c) only treats marketable securities as cash for purposes of I.R.C. sections 731 and 737, not for purposes of I.R.C. section 732. I.R.C. §§ 731(c), 732(b).

[248] *See supra* notes 224–28 and accompanying text.

Pro rata liquidation

Partner	Receives	Recognized Gain (Loss)	Deferred Gain (Loss)
April	33% artwork 33% land 33% marketable securities	$ 200,000 gain under § 737 **$ 200,000 net gain**	None
May	33% artwork 33% land 33% marketable securities	$ 200,000 gain under § 737 **$ 200,000 net gain**	None
June	33% artwork 33% land 33% marketable securities	$ 200,000 gain under § 737 **$ 200,000 net gain**	None

From a tax perspective, April and May have no preference as between a pro rata or non-pro rata liquidation. June, of course, should prefer the pro rata liquidation, for a $200,000 present net gain is preferable to a $300,000 present net gain and a deferred $100,000 loss.[249] But non-tax factors may cause the daughters to prefer non-pro rata distributions. They may no longer wish to be co-owners of assets; they may simply prefer to divide the pie and go their separate ways. When such is the case, there appears to be no reason to force super-recognition upon a partner like June simply because she takes the whole of the loss property instead of insisting on her proportionate share of all assets.

Clearly, the results to June are within the collective control of the daughters. To the extent the partners are free to distribute the assets as they agree, they should generally be bound by the tax consequences of their choice. For one thing, the daughters can avoid the problem entirely if they simply wait until seven years have passed from Augustus's initial contribution of the built-in gain and built-in loss assets until liquidation.[250]

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[249] This is not universally true, of course. If June has an expiring net operating loss carryover or an expiring charitable contribution carryover, for example, June may prefer super-recognition to more fully utilize the expiring losses while retaining the right to an additional $100,000 loss going forward. *See* I.R.C. § 172. Super-recognition is also tolerable if June has a substantial capital loss carryover to absorb the extra capital gain, although she will still have an extra $100,000 capital loss lurking upon disposition of the marketable securities. *See id.* § 1211(b).

[250] *See id.* §§ 704(c)(1)(B), 737(b).

When the partners cannot or will not wait that long, they must consider the possibility of super-recognition where the FLP holds loss property, and then make their final distributions accordingly.

But prospectively, there is no reason to tell the partners of an FLP that they must either impose super-recognition upon a partner taking loss property (with the consolation prize of a deferred loss) or wait seven years before liquidation. This is especially true when the liquidation is not by anyone's account a disguised sale of assets through or by the FLP. Rules intended to thwart disguised sales should not apply to transactions that are not, in fact, disguised sales.

Congress can solve this problem in one of two ways. First, it could limit the maximum amount of gain recognized under section 704(c)(1)(B) to an amount that does not exceed the excess of the partner's unrealized gain at the time of distribution.[251] Alternatively, and perhaps preferably, it could enact a facts and circumstances safe harbor that would permit tax-free liquidations of FLPs where the partners can prove that the liquidation does not effect a disguised sale of property through or by the partnership.

CONCLUSION

This Article advocates extension of the return-to-sender exception to assignees for purposes of section 737 and a limitation on the gain recognized by an assignee under section 704(c)(1)(B). Conceptually, both arguments concern the extent to which, pardon the assonance, an assignee assumes an assignor's interest. If one accepts the premise that assignees should step completely into the shoes of their assignors, the problems of super-recognition and the inconsistent application of the return-to-sender exception should not exist. The assignee of a contributing partner would be seen as the contributing partner, meaning the liquidation of the partnership would often be nothing more than the return of contributed

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[251] One proposal is to amend I.R.C. section 704(c)(1)(B)(i) to read in its entirety as follows: "The contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the lesser of—(I) the gain or loss which would have been allocated to such partner under subparagraph (A) by reason of the variation described in subparagraph (A) if the property had been sold at its fair market value at the time of the distribution, or (II) the gain or loss which such partner would realize upon a sale of such partner's interest in the partnership at the time of the distribution if the amount realized from such sale were equal to such partner's distributive share of the net fair market values of the partnership's assets at such time." A little added complexity to the statute would go a long way toward equalizing the results for partners who watch gain property go to others while they take on loss property.

property to the contributor, a transaction that obviously would be tax-free under the various return-to-sender exceptions discussed in this Article. Furthermore, the return of contributed property to the "contributor" is hardly a disguised sale, so super-recognition would not be an issue.

Saxe's elephant remained remarkably calm, despite excessive tactile probing from its visitors—it apparently made no sound and did not stir.[252] The debate over the family limited partnership is certainly not as calm. The ongoing war between taxpayers and the Service over the legitimacy of the family limited partnership strategy should be contained to the federal wealth transfer tax arena. Permitting the assignee of a family limited partnership interest to step completely into the assignor's shoes not only provides welcome consistency but also helps to keep the family limited partnership battle from spilling into the income tax arena.

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[252] *See* Saxe, *supra* note 1, at 150–51.