XV. THE USE OF FAMILY LIMITED PARTNERSHIPS & FAMILY LIMITED LIABILITY COMPANIES IN ESTATE PLANNING

A. Introduction

The use of family limited partnerships ("FLPs") and family limited liability companies ("LLCs") in estate planning has exploded over the last decade. The popularity of these vehicles as a means of transferring wealth from one generation to the next results from not only the fact that they can help achieve significant transfer tax savings, but also from the fact that they allow families to achieve significant non-tax benefits.

The estate, gift and generation-skipping taxes that can be saved through the utilization of these vehicles have been well documented. A predictable side effect of this publicity is intense scrutiny from the Internal Revenue Service ("IRS"), which, in turn, has resulted in a number of disputes that have worked their way through the nation's court systems. As the IRS has the ability to "pick and choose" cases for audit, the IRS naturally selects the cases with the worst facts from a taxpayer's perspective. Despite this adverse selection process, taxpayers were able to obtain some early victories that eliminated a number of weapons from the IRS's arsenal. However, courts have issued a string of decisions that make estate planning involving FLPs and LLCs a risky endeavor.

This Chapter will review the use of these vehicles in estate planning, focusing particular attention on the following:

- Overview of FLPs and Family LLCs;
- Non-Tax benefits of FLPs and family LLCs;
- Tax benefits of FLPs and Family LLCs;
- Inclusion of FLP/LLC interests under IRC § 2036: the *Strangi* decision;
- Avoiding estate tax inclusion -- formation and operational issues;
- Overview of IRS attacks under the business purpose doctrine, Internal Revenue Code ("IRC") § 2703 and IRC § 2704;
- Avoiding IRS attacks on annual gift tax exclusion for gifts of FLP or family LLC interests; and
- Federal income tax considerations.

B. Brief Overview of FLPs and LLCs

An FLP is simply a partnership created by two or more family members in accordance with state law. The family members contribute property that they expect to appreciate in value and in return receive general partnership interests and/or limited partnership interests. The FLP is managed by the general partners, who have unlimited liability for the activities of the partnership. The limited partners, on the other hand, are essentially passive investors with few, if any, management rights. A limited partner's liability for the activities of the partnership is limited to the amount of his or her investment in the partnership.

> **<u>EXAMPLE</u>:** H and W form an FLP. H contributes a diversified portfolio of securities valued at $250,000 and an interest in real estate worth $250,000 in return for a 1% general partnership interest and a 49% limited partnership interest. W similarly contributes a diversified portfolio of securities valued at $250,000 and an interest in real estate worth $250,000 in return for a 1% general partnership interest and a 49% limited partnership interest.

An LLC, on the other hand, is an entity formed by family members under state law that has characteristics of both a partnership and a corporation. The family members with ownership interests in the LLC are called "members." Like shareholders in a corporation, members are not personally liable for the activities of the LLC. In addition, like partners in a partnership, the legal specifications of one's ownership interest are governed by an operating agreement. An LLC can either be "member-managed," where each member has equal rights in the management and operation of the LLC, or "manager-managed," where a manager or managers specified in the LLC agreement are given the right to manage and operate the LLC. In addition, an LLC could have voting and non-voting membership interests, in which case it is managed by the voting members, or a managing member designated by them.

> **<u>EXAMPLE</u>:** H and W form an LLC. By creating voting and non-voting membership interests, H and W could structure the LLC in an identical manner to the FLP in the previous example. Assuming the same property is contributed, H could receive in return for his contribution a 1% Class A membership interest (with voting rights) and a 49% Class B membership interest (without voting rights). W would receive identical interests in return for her contribution.

The choice of whether to use an FLP or an LLC for estate planning purposes will depend upon which state law the practitioner intends to use. Either entity can be used to accomplish a client's estate planning objectives.

C. Non-Tax Reasons for Using FLPs and Family LLCs

In addition to the highly publicized valuation discounts that can be achieved through the use of FLPs and LLCs, there are a number of non-tax benefits (*e.g.*, the degree of control that one can retain over the assets in these entities vis-à-vis the control one can retain over the assets in a trust without causing estate tax inclusion) that can be achieved through owning assets in these vehicles. Although a number of cases have held that a valid business purpose is not necessary for the entity to be respected for transfer tax purposes (<u>See e.g.</u>, *Knight v. Comm'r,* 115 T.C. 506 (Nov. 30, 2000); *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd and rev'd in part by Gulig v. Comm'r*, 293 F.3d 279 (5th Cir. 2002), there always have been and always will be valid non-tax reasons for establishing a FLP or LLC, including the following:

1. Provides a Vehicle to Transfer Assets while Retaining Control over Distributions to Family Members

In making gifts to descendants, probably the single biggest non-tax benefit derived from

the use of a FLP or LLC, in contrast to the use of a trust, is that the donor can retain control over both the management of the underlying assets and the distributions to his or her descendants. A concern of many wealthy clients is that transferring substantial wealth to descendants will inhibit the initiative of the beneficiaries and may prevent them from becoming productive members of society (*i.e.*, fear that their generosity will spawn a "trust fund baby"). However, waiting to transfer wealth and the corresponding responsibilities until after death means that the donors will be unavailable to help the donees deal with the responsibility of handling substantial wealth.

By creating a FLP or LLC and transferring limited partnership interests or non-voting membership interests, the donor can relieve some of that fear, as the donor is able to retain control over the underlying assets and can reinvest cash flow rather than making distributions. Moreover, because there are substantial transfer restrictions on these interests, they are largely non-marketable and cannot be readily converted by the beneficiary into cash. By contrast, retention of the same degree of control, as trustee of a trust for the benefit of one's descendants, would likely cause the trust assets to be included in the donor's estate (but see section E. below regarding the inclusion of the donor's FLP or LLC interest in his or her gross estate under IRC § 2036).

2. Protection from Creditors and Failed Marriages

A FLP or LLC provides protection from a partner or member's personal creditors (*i.e.*, "outside creditors"), by limiting their remedy to obtaining a "charging order" against the interest in the entity. Unless the partner or member made a fraudulent conveyance of the partner or member's assets to the FLP or LLC, his or her personal creditors cannot reach the entity's assets and, instead, will be limited to obtaining a charging order. A charging order gives the creditor the rights of an assignee of a membership/partnership interest. As such, the creditor is only entitled to receive distributions which otherwise would be made to the partner or member whose interest is charged. Furthermore, the creditor generally may only become a partner/member if all of the other partners consent. In such a case, the creditor cannot vote as a partner or member or exercise other partner/member rights. The entity agreement may be structured to offer the entity or other interest holders the opportunity to buy-out any interest holder whose interest is attached at a price determined pursuant to a formula.

The rationale behind limiting the creditor to assignee status is to prevent a partner or member's individual creditors from seizing entity assets and thereby interrupting the business and adversely impacting innocent partners or members. Because the creditor is limited to a charging order and, thus, cannot force distributions from the entity, the creditor will likely be more willing to settle than if the assets were not held in a FLP or LLC. If the creditor chooses to litigate the matter and obtains a charging order, the creditor could be saddled with income taxes even though no distributions are made to the creditor (*i.e.*, the creditor, and the other partners or members, would be forced to report "phantom income"). See Rev. Rul. 77-137, 1977-1 C.B. 178; Osborne & Schurig, 2 Asset Protection: Domestic and International Law and Tactics § 16.06.

➔ **Planning Point:** Additional creditor protection can be obtained by providing for a buy-out in the partnership or operating agreement that allows the partners or members or the entity itself to purchase the interest at its fair market value (*i.e.*, at the interest's discounted fair market value) if:

(a) an interest holder attempts to assign his or her interest to a person outside the family; (b) an interest is awarded to a non-family member in a divorce proceeding; or (c) a creditor obtains a charging order, as discussed above. An added degree of protection can also be obtained by prohibiting partners or members from pledging their interests for their individual debts.

In addition to providing protection from personal creditors, a FLP or LLC may provide some protection from a divorced spouse, as these vehicles provide a convenient means of ensuring that a child or grandchild does not commingle his or her separate property with that of his or her spouse.

➔ **Planning Point:** Again, additional protection can be obtained by drafting the partnership or operating agreement so that an involuntary transfer of an interest pursuant to a divorce decree will trigger buy-sell provisions that allow the divorced partner or member (in the event the former spouse held an interest in the entity), the other partners or members or the entity itself to purchase the interest at its fair market value. As the fair market value of the interests is less than the value of the underlying interest, even if a court awards the value of an entire interest to the former spouse, the former spouse will not be able to reach the total value of the underlying assets.

3. Consolidate Ownership

FLPs and LLCs can be used to consolidate a family's ownership interest in a "family" asset. For example, a FLP or LLC is an excellent vehicle for holding an interest in a family farm. If owned outside of one of these entities, fractional interests among family lines would result over time, which would make dealing with the asset as a whole extremely difficult (*e.g.*, if a parent transferred his interest in a farm to his three children in equal shares and, at the death of each of the children, they each transferred their one-third share to their three children (*i.e.*, the grandchildren of the original transferor), the farm would be owned in equal shares by nine different individuals). By owning the assets in a FLP or LLC, the general partner or managing member would be able to manage the property on behalf of the others, thereby significantly reducing administrative headaches that result from fractional ownership. In addition, FLPs or LLCs are frequently drafted with buy-sell provisions to keep the family assets within the family.

4. One Level of Federal Income Taxation

Unlike a corporation, in which the corporation pays federal income tax at the corporate level and the shareholders are again taxed at the individual level, the partners of a FLP and the members of a LLC are subject to federal income tax only at the individual level. FLPs and LLCs do not pay federal income tax. Instead, they "pass-through" all taxable items to their partners or members, as the case may be, who are then obligated to report such times on their personal income tax return and to pay any federal income tax due. Some states, however, may impose a state income tax on the entity itself.

5. Facilitate Gifts

Creating a FLP or LLC simplifies the making of gifts to the next generation. The parents may make gifts of their limited partnership interests or membership interests rather than direct gifts of the underlying assets. The gifts can be made by simply signing a form and without the necessity of reregistering securities or accounts. A gift of partnership interests or membership interests should qualify for the gift tax annual exclusion and, if the gift is structured correctly, the exemption from the generation-skipping transfer tax. In addition to annual exclusion gifts, the donor can use a portion or all of the donor's remaining gift tax exemption to transfer more partnership interests or membership interests to family members during the donor's life. See section I. below regarding the qualification of these gifts for the annual exclusion.

6. Investment Advantages

A FLP or LLC can serve as an investment vehicle to consolidate assets and reduce the costs associated with the management of an investment portfolio for the family of the entity's creator. A larger pool of assets also may allow the FLP or LLC to gain access to investment opportunities that would not be available to single investors. Some investment advisors will accept new accounts only if they are a certain minimum size. Forming a FLP or LLC and combining the assets of the participants can allow the FLP or LLC to gain the minimum capital necessary to obtain the services of these advisors. Similarly, the fees for investment advisory, custodial, brokerage and similar services usually decrease as the amount invested decreases.

The parents can also use the entity as a means of teaching their children to handle investment decisions in a responsible manner. For example, if cash flow is tied to productivity and business goals, rather than to the discretion of the trustee or the child's spending habits, the child can better understand the necessity of productivity and goal setting.

7. Flexibility

The partnership agreement (for a FLP) and the operating agreement (for a LLC) can provide that the agreement can be amended or the FLP or LLC terminated with the consent of the partners without adverse tax consequences. This attribute makes a FLP or LLC a more flexible estate planning tool than, for example, an irrevocable trust (but see section E, below regarding the inclusion of the donor's FLP or LLC interest in his or her gross estate under IRS § 2036). In addition, unlike what is often the case with a corporation, a FLP or LLC may be terminated without adverse tax consequences.

8. Decreases Probate Burdens

Many clients have real property outside their domiciliary jurisdictions. Transferring this property to a FLP or LLC will avoid the ancillary probate of these assets. However, such a maneuver may have an unintended adverse tax consequence.

D. Tax Reasons for Using FLPs and Family LLCs

Although there are non-tax reasons for creating FLPs and LLCs, the driving force behind these vehicles is their ability to achieve significant reductions in gift, estate and generation-skipping transfer tax. There are essentially two types of FLPs and LLCs used in estate planning:

the "discount FLP/LLC" and the "frozen FLP/LLC." As the names indicate, the primary tax motive for a discount FLP/LLC is to obtain minority interest and lack of marketability discounts for gift and estate tax purposes, while a frozen FLP/LLC is designed to partially freeze the value of an individual's estate and shift future appreciation to the next generation.

1. Tax Reasons for Creating Discount FLPs/LLCs

A discount FLP/LLC is a technique that can be used both as a value-reduction technique or a value-shifting technique. For individuals with less than $3,000,000, the discount FLP/LLC will primarily be used as a value reduction technique, as people in this economic class typically want to save estate tax, but generally do not want to undertake an annual gift-giving program (*i.e.,* because they will likely need the cash flow, including the cash flow from future appreciation, that is generated from the assets for their own needs). Conversely, for larger estates, this technique may be used as both a value-reduction technique (*i.e.*, an appropriately designed discount FLP/LLC can achieve estate tax savings even if no lifetime gifts are made) and a value-shifting technique (through lifetime gift giving programs).

Regardless of whether the discount FLP/LLC is intended to be used as a value-shifting or value-reducing technique, the key to this type of transaction is achieving valuation discounts. The discounts are generated from the fact that interests in FLPs and LLCs are cloaked with restrictions, such as lack of control, prohibitions preventing interest holders from withdrawing from the entity, and severe limitations on transfers. As a result of these restrictions, the value of these interests may be discounted, thereby permitting the transferor to leverage the amount of wealth he or she is able to give away to family members.

> **EXAMPLE:** The concept of "leverage" can be illustrated as follows: Assume P intends to make a gift of limited partnership interests to C and, for purposes of simplicity, assume that a combined 50% discount is applicable to the FLP interests being transferred. Under these assumptions each gift of $1 of limited partnership interests represents $2 of underlying value.

The discounts that are typically available in the FLP/LLC context are discounts for lack of control and lack of marketability. Discounts for lack of control flow from the fact that the holder of a limited partnership interest (or a minority interest or non-voting interest in the case of an LLC) does not have the ability to manage the underlying assets or direct distributions from the entity. Lack of marketability discounts, on the other hand, flow from the restrictions in the partnership or operating agreement that limit one's ability to transfer his or her interest in the entity (*i.e.*, thereby preventing the development of a ready market for the purchase and sale of interests in the entity). In determining the amount of the discount, several factors must be considered, including the specific provisions partnership or operating agreement, the type of assets held by the entity, the prospect for distributions and the financial risk to the limited partner or member. The discounts can produce substantial transfer tax savings. For estate and gift tax purposes, discounts generally range from 25% to 40%, and may be even higher, depending on the circumstances.

If the primary reason, from a tax perspective, for forming the FLP/LLC is to produce

valuation discounts for estate tax purposes, it may now be important for the taxpayer not to retain any power to participate in liquidating the entity. If a taxpayer, as a partner or member (or as manager of an LLC), has a power to participate in liquidating the entity, all interests in the entity owned by such individual may be valued for estate tax purposes at the value of the entity's underlying assets attributable to the decedent's interest in the entity. The alleged statutory support for this position is IRC § 2036(a)(2).

A discount FLP/LLC can also be used as a value-shifting technique, if the initial partners or members (usually a husband and wife) make lifetime gifts of limited partnership interests or membership interests to their children and other beneficiaries. Using this approach, an individual will typically retain control over the entity (*e.g.*, by retaining the general partnership interests an FLP) and then making gifts of limited partnership interests to his or her children and/or grandchildren (but see section E. below regarding the inclusion of the individual's interest in his or her gross estate under IRC § 2036).

> **EXAMPLE:** H and W each own a 1% general partnership interest and a 49% limited partnership interests in an FLP, which owns $4,000,000 of marketable securities. H and W want to begin transferring assets to their three children, but want to retain the ability to not only manage the securities, but also control the amount and timing of distributions to their children. Accordingly, H and W decide to make annual exclusion gifts (currently $13,000) to each of their children of limited partnership interests. A qualified appraiser determines that a combined 30% discount for minority interest and lack of marketability should apply to their interests in the FLP. As a result, each transfer of $13,000 of limited partnership interests will represent $18,571 of value in the underlying securities ($13,000 ÷ 70%). See Section H. below regarding the qualification of these gifts for the annual exclusion.

2. Tax Reasons for Creating Frozen FLPs/LLCs

Frozen FLPs and LLCs are used primarily as value-shifting devices. The value of the various interests in a frozen FLP/LLC is determined under the special valuation rules contained in IRC § 2701. Although a detailed discussion of the special valuation rules under IRC § 2701 is beyond the scope of this Chapter, the following material provides a general overview of the mechanics of a frozen FLP/LLC and discusses some situations in which a practitioner may want to consider using a frozen FLP/LLC.

In a typical frozen FLP/LLC structure, three classes of interests will be created: (a) a common general partnership interest (typically representing 1% of the value of the FLP); (b) a common or "unfrozen" limited partnership interest (which must represent not less than 10% of the value of the FLP); and (c) a preferred limited partnership interest, which represents the balance of the interests (a similar capital structure would be used for an LLC). The holder of the general partnership interest has the ability to control and manage the entity.

The preferred interest pays the holder a fixed and certain rate of return with no participation

in equity growth, while the holders of the common interests have rights to all income, growth and appreciation in excess of the preferred distributions. Thus, as the holders of the preferred limited partnership interests are assured a fixed and certain rate of return with no participation in equity growth, their interest is referred to as a "frozen" interest. Similarly, as all income, growth and appreciation above the preferred return inures to the holders of the common limited partnership interests, their interest is referred to as an "unfrozen" interest.

The individual creating a frozen FLP typically transfers the common or unfrozen interest to his or her children and/or grandchildren and retains the general partner interest and the preferred limited partner interests. This will partially freeze the value of the interest retained, as all earnings and growth over the preferred amount will pass to the children's common interest (except 1% of such amount inures to the holder of the general partnership interest, thereby causing a "leak" in the freeze).

Depending on the creator's specific circumstances and desires, he or she can either retain control over the entity's activities (by retaining the general partnership interests) and make annual exclusion gifts of the preferred limited partnership interests, or the creator can transfer his or her general partnership interest to his or her children and retain the preferred limited partnership interest (thereby retaining a guaranteed payment right during his or her lifetime).

➔ **Planning Point:** A frozen FLP/LLC will only make sense if the total rate of return generated by the underlying assets exceeds the preferred distribution rate. In fact, if the total rate of return on the underlying assets is less than the preferred distribution rate, the "unfrozen" limited partnership interest which was previously transferred by gift will be paid back to the donor in satisfaction of the preferred distribution (thereby resulting in a "phantom gift"; *i.e.*, a taxable gift that fails to transfer any value). This result would be even worse if the donor's children contributed their own assets in return for the "unfrozen" limited partnership interest, because the children's assets would be paid back to the donor in satisfaction of the preferred distribution amount.

As a result of this risk, practitioners should carefully analyze a situation before opting to use a frozen FLP/LLC. Despite this risk, a frozen FLP/LLC may be well tailored for the following situations:

- The business or other asset in the frozen FLP/LLC is likely to experience significant short-term growth and then likely will be sold. The frozen FLP/LLC is well suited for this type of situation, because the preferred distributions can be deferred for up to four years, thereby providing an additional source of funds to fuel the growth. Upon the sale of the underlying asset, the sale proceeds can be used to pay the distributions that are in arrears and the FLP/LLC can be liquidated with most of the growth inuring to the holders of the "unfrozen" interest.
- The asset in the frozen FLP/LLC consistently generates a predictable total return in excess of the preferred distribution rate.
- Your client wants to purchase a life insurance policy; however, because he or she

fully utilized his or her annual exclusion elsewhere, an irrevocable life insurance trust is not an option. Instead, the policy could be owned by a frozen FLP/LLC. The children own the "unfrozen" limited partnership interests, your client owns the preferred limited partnership interests and an independent third party owns the general partnership interest. At the insured's death, the insurance proceeds effectively inure to the benefit of the children. Only the value of the preferred interest should be included in the parents' gross estate. Other assets would have to be owned by the FLP/LLC so that the entity could use these other assets to pay the insurance premiums. By having the FLP/LLC pay the insurance premiums, the necessity of annual gifts is avoided. Thus, unlike when an irrevocable life insurance trust is used, there is no need for Crummey notices or gift tax returns, and additional GST exemption is not used if skip persons are involved.

J. Income Tax Provisions - Entities Taxed as Partnerships

Although a detailed discussion of the income taxation of partnerships is beyond the scope of this Chapter, the following material (in addition to the investment company rules under IRC § 721(b) discussed above) is intended to guide practitioners to some of the typical income tax provisions that their clients may encounter while operating an FLP or LLC.

1. Taxation of the Entity

Unlike a corporation, in which the corporation pays federal income tax at the corporate level and the shareholders are again taxed on the individual level, the partners of an FLP and the members of an LLC are subject to federal income tax only at the individual level. Partnerships do not pay federal income tax. Instead, they "pass-through" all taxable items to their partners, who are then obligated to report such times on their personal income tax return and to pay any federal income tax due. Income and loss are taxed to the partners or members (whether or not they actually receive a distribution) in proportion to their interest in the FLP or LLC. Some states, however, impose a state income tax on the partnership entity itself.

➔ **Planning Point:** When selecting a state in which to form an FLP or LLC, practitioners should be sure to check whether or not the state imposes a state income tax on the partnership itself. All other things being equal, practitioners will typically want to select a state that does not impose a separate state income tax on the partnership entity.

2. Family Partnership Rules

Under the "family partnership rules" of IRC § 704(e), a person to whom a partnership interest is transferred by gift will not be recognized for income tax purposes (*i.e.*, income will instead be taxed to the donor) unless certain requirements are met. An FLP or LLC should be able to satisfy these requirements provided there are at least some regular distributions, all formalities are observed, and any gifts of partnership interests are made either outright to adult donees or to a trust or Uniform Transfers to Minors Act account that is not controlled by the donor.

3. Allocation of Built-in Gain or Loss on Contribution

Income or loss attributable to appreciation or depreciation existing when property is contributed to the FLP or LLC is allocated to the contributing partner or member under IRC § 704(c).

4. Loss Limitations

Tax losses are typically allocated to limited partners only to the extent of their capital accounts, with the balance being allocated to the general partners. Subsequent income is allocated first to the general partners, to the extent of prior losses (See IRC § 465 "at risk limitations").

5. In-Kind Distributions

Distributions of assets (other than cash, and, in certain cases, marketable securities) upon liquidation or otherwise are generally tax-free to the extent the property distributed does not exceed the distributee partner's basis in his or her partnership interest. Gain will not be recognized by a partner upon the distribution of marketable securities by an "investment partnership," which generally means a partnership that has never engaged in a trade or business and substantially all of the assets of which have always consisted of money, stocks, bonds, derivatives and certain similar other investments (See IRC § 731(c)(3)(A)(iii) and (C)(i)). Also, gain generally will not be recognized upon distribution of marketable securities if a partner receives only his or her pro rata share of such securities held by the partnership.

6. Basis Adjustment

Under partnership tax rules (which also apply to LLCs that are taxed as partnerships), each partner has a basis in the partner's partnership interest ("outside basis") and a share of the partnership's basis in the property owned by the partnership ("inside basis"). If a partner dies, the partner's outside basis will be stepped-up to fair market value. The partner's inside basis, on the other hand, will only receive a step-up in basis if an election is made under IRC § 754. Generally, the election will be made if the basis of the deceased partner's interest in the partnership is higher than a pro rata portion of the partnership assets attributed thereto. The result of this election will be to increase the basis of the partnership assets. The tax items attributable to such increase will generally be allocated to the transferees of the deceased partner's partnership interest.

> **EXAMPLE:** H and W each own 50% of a piece of real estate that they contribute to an FLP. The tax basis of the real estate is $1,000,000. Thus, each partner has an inside basis of $500,000 and an outside basis of $500,000. H dies and his partnership interest is valued at $1,200,000 for estate tax purposes. H's estate's outside basis is $1,200,000. If an IRC § 754 election is made, H's estate's inside basis also becomes $1,200,000.

7. Anti-Abuse Regulations Under IRC § 701

Under the "Anti-Abuse" Regulations, the IRS may attempt to re-characterize a partnership

for income tax purposes under certain circumstances. These regulations apply only for income tax purposes (*i.e.,* not for estate and gift tax purposes). As long as an FLP or LLC is managed in accordance with all formalities, the entity should be able to avoid these rules.

8. Disguised Sale Rules

IRC § 707(a)(2)(B) is designed to prevent the sale of property between a partner and partnership from being structured as a nontaxable contribution and distribution under IRC § 721 and § 731. IRC § 707(a)(2)(B) should not be a problem if distributions are limited to "operating cash flow" under Treas. Reg. § 1.707-4(b) or if contributions and distributions are more than two years apart (See Treas. Reg. § 1.707-3(d)).

When first enacted, IRC § 704(c) did not apply to distributions of contributed property. As a result, a contributing partner could avoid an allocation of pre-contribution gain or loss if the partnership distributed the contributed property to another partner instead of selling the property. Neither the partnership nor the contributing partner normally would recognize gain or loss on the distribution, and built-in gain often was shifted to the distributee partner. To prevent this type of income shifting, IRC § 704(c)(1)(B) provides that, if property contributed by a partner is distributed to another partner within seven years of its contribution, the contributing partner must recognize gain or loss from the sale or exchange of the property in an amount equal to the gain or loss that would have been allocated to that partner under IRC § 704(c)(1)(A). Practitioners should be cognizant of this rule to make sure they do not inadvertently run afoul of the rule.

IRC § 737 was designed to thwart transactions where a partner contributes appreciated property to a partnership and later receives a distribution of other property, with the partnership retaining the contributed property. The concern was that, under the normal contribution and distribution rules, a contributing partner would be able to avoid recognition of gain on a swap of properties when a similar transaction outside the partnership would not have qualified for non-recognition. Under IRC § 737, a contributing partner will recognize gain if the partner contributes appreciated property to a partnership and within seven years of the contribution receives property other than money as a distribution from the partnership. The gain will be recognized to the extent the value of other property distributed to the partner by the FLP or LLC exceeds the partner's outside basis (*i.e.*, the partner's basis in his or her partnership interest).

➔ **Planning Point:** IRC § 737 will not apply (even if the contribution and distribution occur within the seven-year time period) if the distributed property was contributed by the partner to whom it is distributed.