

Special Session II-B

Family LPs and LLCs: The Unwind

Closely-Held Business Planning Series

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FAMILY LPs AND LLCs: THE UNWIND

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I. Background

- A. Much attention has been given to the formation of family limited liability companies (“FLLCs”) and family limited partnerships (“FLPs”), and the benefits of properly establishing and operating these entities. Some of these benefits include: retention of control by senior family members, ease of gifting, engaging younger family members in the business and investment activities, creditor protection and valuation discounts.
- B. FLPs and FLLCs unwind in whole (i.e., a complete liquidation) or in part (i.e., the redemption of the interest of a partner) due to a number of circumstances including:
1. the death of one or more of the senior family members;
 2. concerns about potential attacks by the IRS or other taxing authorities; or
 3. the desire of one or more family members to disengage.
- C. Unwinding an FLP or FLLC poses a number of income tax issues that may be overlooked, particularly if the expertise of the advisor is more concentrated on estate planning than income taxation.

II. Formation of the FLP or FLLC

A. Base Case

1. In January 2000, Parents form PPM, LLC. Parents each contribute a one-half interest in the following assets to the entity:

	FMV	Cost Basis ¹	IRC § 704(c) Gain
Cash	\$ 100,000	\$ 100,000	-0-
Marketable securities	\$1,000,000	\$ 200,000	\$ 800,000
Undeveloped land	\$ 800,000	\$ 300,000	\$ 500,000
Apartment building	<u>\$1,100,000</u>	<u>\$ 400,000</u>	<u>\$ 700,000</u>
Total assets	<u>\$3,000,000</u>	<u>\$1,000,000</u>	<u>\$2,000,000</u>
Liabilities	-0-	-0-	
Equity:			
Father	\$ 1,500,000	\$ 500,000	\$1,000,000
Mother	\$ 1,500,000	\$ 500,000	\$1,000,000
Total liabilities and equity	<u>\$ 3,000,000</u>	<u>\$1,000,000</u>	<u>\$2,000,000</u>

B. Income Tax Issues

1. Tax-Free Formation: The Investment Company Issue. As a general rule, no gain or loss is recognized either by Parents or by PPM, LLC upon formation. IRC § 721(a).² Gain (or loss) is

¹ The FLP's or FLLC's basis for its assets is sometimes referred to as "inside" basis while each partner's or member's basis in his or her interest is sometimes referred to as "outside" basis.

² All references to “IRC” are to the Internal Revenue Code of 1986, as amended.

recognized, however, by the parties contributing property to an “investment company.” IRC § 721(b). (An identical rule applies to transfers to corporations that are deemed to be investment companies pursuant to the tests set forth below. See IRC § 351(e)(1).) If an FLP or FLLC is treated as an investment company, the partners or members will recognize gain (or loss) measured by the difference, if any, between the fair market value of the interest received (generally, the fair market value of the property transferred) and the partner’s or member’s tax basis in the transferred property.

- a. A contribution to an FLP or FLLC will be treated as a transfer to an investment company if the following two requirements are met immediately after the transfer:
 - (1) The transfer results in the direct or indirect “diversification” of the transferor’s interests; and
 - (2) The transfer is made to an FLP or FLLC in which more than 80% of the value of the assets (excluding cash and nonconvertible debt obligations) are held for investment, and either are (i) readily marketable stocks or securities or (ii) are interests in regulated investment companies or real estate investment trusts. Treas. Reg. § 1.351-1(c)(1), (2).
- b. In the context of an FLP or FLLC, the critical test typically will be whether 80% of the value of the contributed assets consist of readily marketable stock or securities. For these purposes, stocks and securities are “readily marketable” if they are traded on a securities exchange or traded or quoted regularly in the over-the-counter market. Treas. Reg. § 1.351-1(c)(3).

EXAMPLE 1: Parents formed PPM, LLC by each contributing an undivided interest in real estate worth \$1,900,000, marketable securities worth \$1,000,000, and cash of \$100,000. PPM, LLC would not be deemed to be an investment company within the meaning of IRC § 721(b) since readily tradeable stocks and securities constitute only one-third of its assets.³

- c. The regulations provide that “[a] transfer ordinarily results in the diversification of the transferor’s interest if two or more persons transfer nonidentical assets...” in the exchange. Treas. Reg. § 1.351-1(c)(5).

EXAMPLE 2: If Father transfers 100 shares of Microsoft stock to a partnership and Daughter transfers 100 shares of Google, there is diversification. However, if Father and Daughter each transfer 50 shares of Microsoft and 50 shares of Google, diversification has not occurred.

- d. Diversification does not occur if the nonidentical assets transferred constitute only an “insignificant amount” of the total assets transferred. The regulations indicate that contributions that in the aggregate represent no more than 1% of the total FLP or FLLC capital will be considered an insignificant amount. Treas. Reg. § 1.351-1(c)(6), Examples (1) and (2).
- e. The IRS takes the position that an impermissible diversification can occur if one party contributes marketable securities and the other party contributes more than an insignificant amount of cash. Rev. Rul. 87-9, 1987-1 C.B. 134.
- f. The investment company rules create significant challenges in structuring FLPs and FLLCs that hold marketable securities. The best approach is to have the client contribute the securities (or perhaps the client and his or her spouse contribute identical securities)

³ Pursuant to IRC § 1041 and with proper planning, gain or loss is not recognized if an FLP or FLLC is formed solely between husband and wife. See, e.g., PLR 200317011 (4/25/03).

and have the other parties (such as children) each contribute a nominal amount of cash or securities. After the FLP or FLLC is formed, the parents could make gifts of interests to the children to increase their interests in the FLP or FLLC.

- g. The IRS made the process easier by enacting a provision under IRC § 351 regulations pursuant to which an FLP or FLLC will not be treated as an investment company if each of the transferors to the FLP or FLLC transfers an already diversified portfolio of stocks and securities. Treas. Reg. § 1.351-1(c)(6)(i). A portfolio is considered to be diversified if no more than 25% of the portfolio is invested in one issue of stock, and no more than 50% of the portfolio is invested in five or fewer issues of stock. For purposes of calculating the total value of the portfolio, cash is not counted. Government securities are counted in determining the total value of the portfolio, unless they were acquired to meet the 25 and 50-percent tests.

EXAMPLE 3: Father has a \$1,000,000 securities portfolio with \$200,000 of stock A, \$50,000 each of stocks B, C, D, E, F, and G, and \$500,000 of numerous government securities (held for a substantial period of time). Daughter also has a \$1,000,000 securities portfolio with \$100,000 each of stocks H, I, J, and K and \$50,000 of twelve other stocks. Neither Father nor Daughter has more than 25% of his or her portfolio in any one stock (Father comes closest with 20% in stock A), or more than 50% of the portfolio in 5 or fewer stocks (Father has 50% in 7 stocks and Daughter has 50% in 6 stocks). Father and Daughter will not recognize gain or loss if they contribute their respective portfolios to FLLC.

EXAMPLE 4: Same facts as above except that Father has \$200,000 of government securities and \$300,000 of cash, instead of \$500,000 of government securities. The cash is not counted in determining whether the portfolio is diversified. Stock A now constitutes 28.6% of Father's portfolio (\$200,000/\$700,000), so Father's portfolio is not diversified. If Father and Daughter form an FLLC, they both will recognize gain at the time of formation.

- 2. Disguised Sale Rules. Pursuant to IRC § 707(a)(2)(B), the IRS can treat certain contributions to an FLP or FLLC as a disguised sale, with the result that the contributing party will recognize gain (or loss).⁴

- a. A transaction may be treated as a disguised sale between partners or members if the FLP or FLLC transfers money or other consideration (including the assumption of, or taking subject to, a liability) to a contributing party in connection with the party's contribution to the FLP or FLLC.

EXAMPLE 5: Assume that Father contributes property with a fair market value of \$100,000 and an adjusted basis of \$40,000 to PPM, LLC. Daughter contributes cash of \$75,000. In order to equalize the contributions of the members, Father receives a cash distribution of \$25,000.

Under IRC § 707(a)(2)(B), Father would be treated as selling a 25% undivided interest in the property to Daughter in exchange for the \$25,000 of cash. As a result, Father has a \$15,000 gain computed by subtracting \$10,000 (i.e., one quarter of his \$40,000 basis in the property he contributes) for the property from the \$25,000 of cash received. Father would be deemed to contribute \$75,000 of property with a basis of \$30,000 to PPM, LLC under IRC § 721. Daughter would be deemed to contribute \$50,000 of cash and the \$25,000 interest in the property (with a basis of \$25,000) to PPM, LLC.

⁴ Typically, taxpayers are not looking to affirmatively defer loss recognition, however. Further, IRC § 707(b) disallows deductions for losses resulting from sales or exchanges of property between a partnership and a person who, directly or indirectly, owns more than a 50% interest in the capital or profits of the partnership.

- b. In order for there to be a disguised sale, the transfers do not necessarily have to occur simultaneously. The regulations set out ten facts and circumstances that may tend to prove the existence of a sale. Treas. Reg. § 1.707-3(b)(2). Transfers made within two years are presumed to be sales, and transfers made more than two years apart are presumed not to be sales. Treas. Reg. § 1.707-3(c) and (d).
- c. These rules also must be consulted in connection with a freeze transaction since, by definition, one or more family members will be entitled to receive a preferred cash distribution or guaranteed payment after formation of the FLP or FLLC. As a general rule, “reasonable” guaranteed payments for capital and preferred returns are presumed to be outside of the reach of the disguised sale rules, provided that the facts and circumstances do not clearly establish that such payments are part of a disguised sale. Treas. Reg. § 1.702-4(a)(1)(ii), (iii), (2), (3).
 - (1) Guaranteed payments and preferential returns are deemed to be reasonable if they do not exceed 150% of the highest applicable Federal rate, using the appropriate compounding periods, in effect during the taxable year in which the frozen interests are created. Treas. Reg. § 1.707-4(a)(3)(ii).
 - (2) A frozen FLP or FLLC interest may fall outside of the safe harbor described above because the preferential return necessary to support the value of the interest may exceed 150% of the highest applicable federal rate then in effect. If this occurs, the practitioner must carefully structure the FLP or FLLC so there are no other aspects of the transaction that would lead the IRS to conclude that there is a disguised sale.

III. Transition of the FLP or FLLC to the Next Generation

- A. Over their lifetimes, Father and Mother make gifts of their interests in PPM, LLC to their children, Peter, Paul and Mary. Assume the assets of PPM, LLC currently remaining are as follows:

	FMV	Tax Basis of Capital Accounts	IRC § 704(c) Gain⁵	Total Unrealized Gain
Cash	\$ 100,000	\$ 100,000	-0-	-0-
Marketable securities	\$2,000,000	\$ 200,000	\$ 800,000	\$1,800,000
Undeveloped land	\$1,900,000	\$ 300,000	\$ 500,000	\$1,600,000
Apartment building	<u>\$2,000,000</u>	<u>\$ 400,000</u>	<u>\$ 700,000</u>	<u>\$1,600,000</u>
Total assets	<u>\$6,000,000</u>	<u>\$1,000,000</u>	<u>\$2,000,000</u>	<u>\$5,000,000</u>
Liabilities	-0-	-0-		
Equity: Peter	\$2,000,000	\$ 333,334	\$ 666,666	\$1,666,666
Paul	\$2,000,000	\$ 333,333	\$ 666,667	\$1,666,667
Mary	<u>\$2,000,000</u>	<u>\$ 333,333</u>	<u>\$ 666,667</u>	<u>\$1,666,667</u>
Total liabilities and equity	<u>\$6,000,000</u>	<u>\$1,000,000</u>	<u>\$2,000,000</u>	<u>\$5,000,000</u>

- B. Overview of the Partnership Distribution Rules

1. Flow Through Tax Treatment. An FLP or FLLC is not itself a taxpaying entity. The income, deductions and credits of these entities flow through the entity and are taxed directly to the

⁵ As noted later in this outline, it is necessary to track the built-in gain (or loss) attributable to Parents’ initial contributions to the LLC (determined as of the date of their contribution to the entity rather than the date on which gifts of the entity interests are made to the children) even though Parents have given those interests to their children. Peter, Paul and Mary are deemed to “step into the shoes” of Parents for purposes of continuing to track such gain or loss as required under IRC § 704(c). See Treas. Reg. § 1.704-4(d)(2).

partners or members. IRC § 701. The partners' and members' responsibility for the payment of tax on the taxable income of the entity is not dependent on whether the FLP or FLLC actually makes distributions of cash or other assets to the partners or members. A partner or member may have tax obligations from the FLP or FLLC in a given year in excess of his distribution from the FLP or FLLC.

2. Tax Treatment of Entity. No gain or loss is recognized by an FLP or FLLC when it distributes property or cash to a partner or member. IRC § 731(b).
3. Tax Treatment of Partners and Members: General Rules.

- a. Generally, profits of an FLP or FLLC can be distributed to the partners or members tax-free to the extent that the distribution does not exceed the partner's or member's basis in his interest. IRC § 731(a).
- b. A partner or member of an FLP or FLLC only recognizes gain to the extent that cash (including marketable securities treated as cash in certain circumstances, as discussed below) exceeds the partner's or member's basis in his interest immediately before the distribution.

EXAMPLE 6: Assume that PPM, LLC distributes \$10,000 of cash to each of Peter, Paul and Mary. The members recognize no gain as a result of the distribution, but each of their tax bases in the member interests are reduced by \$10,000.

- c. Distributions of property generally are not taxable upon receipt by a partner or member. IRC § 731(a)(1). Certain exceptions (explained below) apply. The partner or member takes a tax basis in the property equal to the lesser of (a) the FLP's or FLLC's tax basis in the asset and (b) the partner's or member's remaining tax basis (after first taking into account all cash distributions received) in his partnership interest. IRC §§ 732(a); 733.

EXAMPLE 7: Assume that, in addition to the \$10,000 of cash distributed to each member in Example 6 above, PPM, LLC also distributes an undivided one-third interest in the undeveloped land to each of Peter, Paul and Mary. Assume further that the LLC has been in existence for over 7 years and Father and Mother contributed undivided interests in that land to the LLC upon formation.

Each member's tax basis starts at \$333,333. That basis is first reduced by the \$10,000 of cash distributed to \$323,000 (rounded).

Next, each member's basis is reduced for the distribution of the land. Because the LLC's tax basis for a one-third interest in the land is \$100,000 ($\$300,000 \div 3 = \$100,000$) which is less than each member's remaining tax basis (\$323,000), each member takes a tax basis in the undeveloped land equal to \$100,000. Each member's basis in his or her interest in the LLC is also reduced by \$100,000 to \$223,000 due to the distribution of the land.

- d. A distributee partner's or member's holding period in the assets received from the FLP or FLLC includes the entity's holding period for the asset. IRC §§ 735(b); 1223(2). Likewise, the entity's holding period includes the holding period of the contributing partner or member, assuming that gain or loss is not recognized when the property is contributed to the entity. Treas. Reg. § 1.723-1.

EXAMPLE 8: Referring to the facts of Example 7, if Peter sells his undivided interest in undeveloped land for more than \$100,000 one month after the receipt of the property from PPM, LLC, Peter would be entitled to long-term capital gain treatment, provided that PPM, LLC and Peter's Parents held the property for at least an aggregate of 12 months and 1 day.

4. Tax Treatment of Partners and Members: Special Rules for Distributions of Marketable Securities.

- a. Because of certain perceived abuses involving in-kind distributions of marketable securities, these distributions now generally are treated the same as cash for purposes of the FLP and FLLC distribution rules. So a partner or member generally recognizes gain to the extent he or she receives an in-kind distribution of marketable securities having a fair market value on the distribution date that is greater than the partner's or member's basis in the FLP or FLLC. IRC § 731(c)(1).
- b. For these purposes, "marketable securities" is defined to include, among other things:
 - (1) actively traded "financial instruments" (i.e., stocks, debt instruments, options, forward and future contracts, notional principal contracts and derivatives);
 - (2) actively traded foreign currencies;
 - (3) interests in common trust funds, mutual funds and other regulated investment companies;
 - (4) a financial instrument which is readily convertible into cash or a marketable security;
 - (5) a financial instrument whose value is determined substantially with reference to a marketable security;
 - (6) precious metals; and
 - (7) interests in certain entities owning cash and marketable securities. IRC § 731(c)(2).
- c. Several exceptions to the Code § 731(c) rule apply, the two most significant of which are discussed in subparagraphs d. and e. below:
- d. Marketable securities contributed to an FLP or FLLC by the distributee partner are not treated like cash. IRC § 731(c)(3)(A)(i).

Caution: Neither Code § 731(c) nor the applicable Treasury Regulations contain a "step in the shoes" concept. Father and Mother were the original contributors of assets to PPM, LLC. Peter, Paul and Mary, in contrast, are donees who received their interests as gifts from Parents. For many purposes of the Code, a donee takes the "tax history" of the transferor, and it would be logical to assume that Peter, Paul and Mary, as donees of interests from Parents, should be treated like they were "contributors" to PPM, LLC for purposes of IRC § 731(c)(3)(A)(i). Unfortunately, the Code and Regulations are silent on this point and Peter, Paul and Mary will not be treated as contributors to PPM, LLC and are not able to take advantage of this exception.

- e. The FLP or FLLC is an "investment partnership" and the distributee partner or member is an "eligible partner" thereof.
 - (1) An "investment partnership" is one which has never actively engaged in a trade or business (other than as an investor, trader or dealer in marketable securities) and substantially all (i.e., at least 90%) of the assets (at least 90%) of which have always consisted of cash, stock, debt instruments, foreign currencies and certain similar assets. IRC § 731(c)(3)(C)(i).

EXAMPLE 9: Because PPM, LLC owns undeveloped land and rental real estate, it does not qualify as an investment partnership for purposes of Code § 731(c).

- (2) An “eligible partner” is a person who did not contribute assets to the partnership other than those identified in (1) above. IRC § 731(c)(3)(C)(iii).

Caution: It is unclear whether a donee of an FLP or FLLC can be an eligible partner if his or her donor was an “eligible partner”. Arguably, the donee should be eligible if he or she did not contribute any assets to the FLP or FLLC that would have disqualified the entity based on the asset test described in (A) above. Many practitioners believe that a “step in the shoes” concept should apply to donees of investment partnerships who receive their interests from eligible donors. See IRC § 731(c)(3)(C)(iii)(II).

- f. Even if Code § 731(c) applies, the amount of the distribution that the distributee is required to treat as a distribution of cash is decreased by the difference between (i) the gain the distributee would have recognized if all marketable securities distributed were instead sold immediately prior to the distribution and (ii) the distributee’s share of the gain attributable to the remaining marketable securities immediately after the distribution. IRC § 731(c)(3)(B).

EXAMPLE 10: Assume that PPM, LLC distributes one-half of its marketable securities (worth \$1,000,000 with a cost basis of \$100,000) in equal shares to Peter, Paul and Mary. Each of Peter, Paul and Mary has a cost basis of \$333,333 for his or her interest in PPM, LLC.

Since the LLC does not qualify as an investment partnership, the distribution must be analyzed under the special limitation rule contained in Code § 731(c)(3)(B):

Member’s 1/3 share of gain attributable to marketable securities prior to distribution	
$[(\$2,000,000 - \$200,000) \div 3]$	\$ 600,000
Less: Member’s 1/3 share of gain attributable to the remaining marketable securities held by the LLC immediately after the distribution:	
$[(\$1,000,000 - \$100,000) \div 3]$	< \$ 300,000 >
Amount (per Member) not treated as cash	<u>\$ 300,000</u>
Amount (per Member) treated as cash	<u>\$ 33,333</u>

Outside Basis Adjustment

Each of Peter’s, Paul’s and Mary’s outside basis for his or her interest in the LLC needs to be adjusted. Sec. Treas. Reg. § 1.731-2(f)(1). Each of his or her cost basis starts at \$333,333 and their cost basis is reduced by the lesser of (i) the LLC’s basis for the securities distributed (\$33,333), and (ii) the member’s basis \$333,333. Therefore, each of Peter’s, Paul’s and Mary’s outside basis is reduced by \$33,333 to \$300,000 (\$333,333 less \$33,333).

Basis in Securities

Each of Peter, Paul and Mary also has a cost basis in the securities received. Because no gain was recognized on the transaction, each has a basis of \$33,333 in the \$333,333 of securities received. See Treas. Reg. § 1.731-2(f)(2).

EXAMPLE 11: Assume that PPM, LLC distributes one-half of its marketable securities (worth \$1,000,000 with a cost basis of \$100,000) in equal shares to Peter, Paul and Mary. In this case, however, assume that each of Peter, Paul and Mary has a cost basis of \$23,333 for his or her interest in PPM, LLC.

Since the LLC does not qualify as an investment partnership, the distribution must be analyzed under the special limitation rule contained in Code § 731(c)(3)(B):

Member's 1/3 share of gain attributable to marketable securities prior to distribution [(\$2,000,000 - \$200,000) ÷ 3]	\$ 600,000
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Less: Member's 1/3 share of gain attributable to the remaining marketable securities held by the LLC immediately after the distribution: [(\$1,000,000 - \$ 100,000) ÷ 3]	< \$ 300,000 >
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Amount (per Member) not treated as cash:	\$ 300,000
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Amount (per Member) treated as cash	\$ 33,333
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Outside Basis Adjustment

Each of Peter's, Paul's and Mary's outside basis for his or her interest in the LLC needs to be adjusted. Each of his or her cost basis starts at \$23,333. Each of them has received a cash distribution of \$ 33,333 and a property distribution of \$300,000.

In this example, each of Peter, Paul and Mary has insufficient basis to absorb a cash distribution of \$33,333 (his or her basis is only \$23,333), so each will recognize a gain of \$10,000 (\$33,333 less \$23,333) under the special rules of IRC § 731(c). The cost basis for each of their interests in the LLC is increased by the gain recognized to \$33,333 (\$23,333 plus the \$10,000 gain on the cash distribution of \$33,333). Treas. Reg. § 1.731-2(f)(1).

Additionally, each of them has received a distribution of marketable securities. Each of their outside bases must be reduced by the lesser of (i) the LLC's basis for the assets distributed (\$33,333), and (ii) the member's adjusted basis of \$33,333. As a result, each of their outside bases are reduced to zero as a result of the distribution. Note that the amount of securities distributed but treated as cash does not decrease their outside bases. See Treas. Reg. § 1.731-2(f)(1)(ii).

Basis in Securities

To the extent that distributed marketable securities are treated as cash, the distributee's tax basis in the securities is increased by the amount of gain recognized on receipt. IRC § 731(c)(4). Because gain was recognized on the transaction, each has a basis of \$33,333 in the \$333,333 worth of securities received.

5. **Tax Treatment of Partners and Members: Special Rule for Pre-Contribution Gain Property.** Special rules apply to distributions of property in kind if, within the previous seven (7) years, that property (or other property) has been contributed to the FLP or FLLC.

- a. Code § 704(c)(1) requires that pre-contribution gain or loss attributable to property contributed to an FLP or FLLC be allocated to the contributing party.

EXAMPLE 12: Mother and Son form MS Partnership. Mother contributes cash of \$1,000 and Son contributes Blackacre having a value of \$1,000 although Son's tax basis in the land is only \$400. Thus, there is \$600 of built-in gain attributable to Blackacre. Mother and Son share profits and losses on an equal basis.

Assume that one year after MS Partnership is formed, Blackacre is sold for \$1,500, generating a total taxable gain of \$1,100 (\$1,500 less the \$400 basis). The first \$600 of gain (i.e., the pre-contribution gain) must be allocated entirely to Son who contributed the

property to MS Partnership. The remaining \$500 of gain is allocated equally to Mother and Son (\$250 each).

- b. Distribution of Contributed Property. In order to ensure that the built-in gain rules are not circumvented, if property contributed to an FLP or FLLC by a party is, within 7 years of the date of contribution, distributed in kind to another partner or member, the contributor must recognize gain or loss (to the extent of the built-in gain or loss) as if the property had been sold for cash at the time of the distribution. IRC § 704(c)(1)(B).

EXAMPLE 13: Referring to the facts of Example 12, if Blackacre is distributed to Mother (who had contributed cash to MS Partnership) within 7 years of the formation of MS Partnership, Son would recognize built-in gain of \$600 (assuming that the property had not decreased in value from its \$1,000 date of contribution value).

- c. Character of Gain. The character of the gain or loss is determined with reference to the character of the gain or loss that would occur if the FLP or FLLC had, in fact, sold the property. IRC § 704(c)(1)(C).
- d. Step in the Shoes. The applicable Treasury Regulations contain an express “step into the shoes” rule for transferees of partners or members who have made in-kind contributions of property. Treas. Reg. § 1.704-4(d)(2). This rule applies only to the extent of the share of built-in gain or loss allocated to the transferee partners or members. See Treas. Reg. § 1.704-3(a)(7).
- e. Distribution of Other Property. A companion anti-abuse rule can be found in IRC § 737 that requires gain (but not loss) recognition by a partner or member who previously contributed property with pre-contribution gain to the FLP or FLLC if, within seven (7) years of the contribution, other property is distributed to the partner or member. Gain is limited to the lesser of:
 - (1) the difference between the fair market value of property (other than money) distributed to the partner or member and the partner’s or member’s basis in his interest, and
 - (2) the amount of pre-contribution gain attributable to the partner or member.

There is an express “step in the shoes” rule under Code § 737 for purposes of determining the amount of the transferor’s net pre-contribution gain attributable to the transferee. Treas. Reg. § 1.737-1(c)(2)(iii). Although it is not entirely clear, presumably the step in the shoes concept also applies to exempt the transaction from tax under IRC § 737 if the transferee receives a distribution of property previously contributed by the transferor.

EXAMPLE 14: Refer back to Example 12. Assume MS Partnership used the \$1,000 of cash contributed by Mother to purchase Whiteacre which is distributed to Son within 7 years of the formation of the partnership. Assume that Whiteacre has a value of \$1,000 when it is distributed to Son. The distribution causes Son’s entire pre-contribution gain of \$600 to be triggered. Son’s basis in MS Partnership is increased to \$1,000, i.e., by the \$600 of gain recognized. IRC § 737(c)(1). This basis increase is deemed to occur immediately prior to the distribution Whiteacre. When the distribution is deemed to be made, Son’s basis in the partnership is reduced by \$1,000 (the partnership’s basis in Whiteacre) and he ends up with a \$1,000 basis in Whiteacre.

- f. The character of the gain triggered under IRC § 737 is determined with respect to the pre-contribution gain of the partner or member, but assuming the property was sold by the FLP or FLLC rather than distributed in kind. See Treas. Reg. § 1.737-1(d).
6. Ordering Rules. If a distribution results in the application of IRC § 731(c) and one or both of IRC §§ 704(c)(1)(B) and 737, the following ordering rules apply:

- a. IRC § 704(c)(1)(B) is applied first and the distributee's outside basis is first increased or decreased as required by IRC § 704(c)(1)(B)(iii).
 - (1) The partner or member recognizing gain (or loss) under IRC § 704(c)(1)(B) has his or her outside basis increased (decreased) as a result. Treas. Reg. § 1.704-4(e)(1).
 - (2) The FLP's or FLLC's basis in the property is increased (decreased) by the amount of gain (loss) recognized by the partner or member, and such adjustments are deemed to occur immediately prior to the distribution of the property in question. Treas. Reg. § 1.704-4(e)(2).
- b. Next, IRC § 731(c) is applied. As result, for purposes of calculating gain under IRC § 731(c), the distributee's outside basis does not include any gain required to be recognized under IRC § 737(c)(1).
- c. Finally, IRC § 737 is applied. Treas. Reg. § 1.731-2(g). The application of these ordering rules is illustrated in the liquidation by non-pro rata in-kind distribution of assets set forth at Section IV.D below.

IV. Complete Liquidation.

- A. Assume that Peter, Paul and Mary want to liquidate PPM, LLC and go their own respective ways. There are several ways that PPM, LLC could be liquidated.
- B. Sale of Assets Followed By a Distribution of Cash.
 1. Under the first option available to the members of PPM, LLC, they could sell all of the assets and then distribute cash to each member.
 2. Immediately prior to the sale, assume that PPM, LLC's assets are as follows:

	FMV	Tax Basis of Capital Accounts	Remaining Code § 704(c)	Total Unrealized Gain
Cash	\$ 100,000	\$ 100,000	-0-	
Marketable securities	\$2,000,000	\$ 200,000	\$ 800,000	\$1,800,000
Undeveloped land	\$1,900,000	\$ 300,000	\$ 500,000	\$1,600,000
Apartment building	<u>\$2,000,000</u>	<u>\$ 400,000</u>	<u>\$ 700,000</u>	<u>\$1,600,000</u>
Total assets	<u>\$6,000,000</u>	<u>\$1,000,000</u>	<u>\$2,000,000</u>	<u>\$5,000,000</u>
Liabilities	-0-	-0-		
Equity: Peter	\$ 2,000,000	\$ 333,334	\$ 666,666	\$1,666,666
Paul	\$2,000,000	\$ 333,333	\$ 666,667	\$1,666,667
Mary	<u>\$ 2,000,000</u>	<u>\$ 333,333</u>	<u>\$ 666,667</u>	<u>\$1,666,667</u>
Total liabilities and equity	<u>\$ 6,000,000</u>	<u>\$1,000,000</u>	<u>\$2,000,000</u>	<u>\$5,000,000</u>

EXAMPLE 15 PPM, LLC has assets with a fair market value of \$6,000,000 and a cost basis of \$1,000,000. PPM sells all of its assets and distributes the cash to Peter, Paul and Mary. The taxable gain on the sale of the assets equals \$5,000,000, which is allocated equally to each of Peter, Paul and Mary (\$1,666,667 each) and reflected on their final K-1s from PPM, LLC. The gain increases each member's tax basis to \$2,000,000, which is the exact amount of liquidating distributions each is entitled to receive. Under IRC §731, none of the members recognize gain or loss upon the actual receipt of his or her share of the \$6,000,000 of cash liquidating distributions since the amount of cash they receive does not exceed their respective tax basis in the PPM, LLC interests.

3. Below is a chart showing the distribution of assets:

	Peter	Paul	Mary	Total
Cash Distributed	\$2,000,000	\$2,000,000	\$2,000,000	\$6,000,000
Basis immediately prior to sale of assets	\$333,334	\$ 333,333	\$ 333,333	\$1,000,000
Plus: Gain allocated due to sale of assets	\$1,666,666	\$1,666,667	\$1,666,667	\$5,000,000
Basis immediately prior to distribution of cash	<u>\$2,000,000</u>	<u>\$2,000,000</u>	<u>\$2,000,000</u>	<u>\$6,000,000</u>
Gain on distribution of cash	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>

C. Liquidation by Pro-Rata In-Kind Distribution of Assets.

1. Instead of selling all of the assets of PPM, LLC, assume that Peter, Paul and Mary will receive an equal 1/3 interest in each of the assets of PPM, LLC. As a general rule, distributions in kind are not taxable.
2. In this case, cash and marketable securities have been distributed in excess of each Member's basis in his or her interest in the LLC. The amount of marketable securities treated like cash is determined with regard to the limitation rule contained in Code § 731(c)(3)(B) as indicated below.
3. Below is a chart showing the distribution of assets:

	Peter	Paul	Mary	Total
Fair Market Value of All Assets Distributed	\$2,000,000	\$2,000,000	\$2,000,000	\$6,000,000
Basis immediately prior to liquidation	\$ 333,334	\$ 333,333	\$ 333,333	\$1,000,000
	Securities⁶	Land	Apartment	Total
Partnership Basis	\$ 200,000	\$ 300,000	\$ 400,000	\$ 900,000
Unrealized Gain	\$1,800,000	\$1,600,000	\$1,600,000	\$5,000,000
% of Unrealized Gain	<u>36%</u>	<u>32%</u>	<u>32%</u>	<u>100%</u>

⁶ The examples contained in the 731(c) regulations only deal with basis calculations in the context of non-liquidating distributions to the partners. Liquidating distributions are controlled by IRC § 732 and Treasury Regulation § 1.732-1(b). These rules require cash to first be subtracted from the partner's outside basis and the remaining outside basis to be allocated among the properties received by the partner in liquidation. IRC § 731(c)(1) treats the distribution of marketable securities as "money," but only for purposes of IRC §§ 731 and 737; not for purpose of IRC § 732.

The remaining basis of each member is allocated to marketable securities received by each member along with each member's undivided interest in the undeveloped land and the member's undivided interest in the apartment building is based upon the partnership's adjusted basis in those assets immediately prior to the distribution. Treas. Reg. § 1.732-1(c)(1). Any excess (or deficiency) between PPM, LLC's ("inside") basis and the member's remaining ("outside") basis is allocated among the assets distributed based upon the relative amounts of unrelated appreciation or depreciation attributable to each such assets. See Treas. Reg. § 1.732-1(c)(2).

	Peter	Paul	Mary	Total
Allocation of Remaining Outside Basis	<u>\$ 36,000</u>	<u>\$ 32,000</u>	<u>\$ 32,000</u>	<u>\$ 100,000</u>
Total Basis to Be Allocated	<u>\$ 236,000</u>	<u>\$ 332,000</u>	<u>\$ 432,000</u>	<u>\$1,000,000</u>
	<u>÷3</u>	<u>÷3</u>	<u>÷3</u>	<u>÷3</u>
Basis Per Partner	<u>\$ 78,666</u>	<u>\$ 110,667</u>	<u>\$ 144,000</u>	<u>\$ 333,333</u>

Each member's share of gain attributable to securities held by LLC immediately prior to liquidation $[(\$2,000,000 - \$200,000) \div 3]$

\$600,000

Each member's share of gain attributable to securities held by LLC immediately after the liquidation

\$ -0-

Securities not treated as cash

\$600,000

Securities treated as cash

\$ 66,667

Because the amount of money deemed to be received by the members does not exceed their outside bases of \$333,333, no gain is recognized by any member.

- D. Liquidation by Non-Pro-Rata In-Kind Distribution of Assets. Assume the LLC assets are distributed in kind among the members in a non-pro-rata manner:

1. Below is the allocation of the assets among the owners:

	Peter	Paul	Mary
Cash	\$ 100,000		
Undeveloped land	\$1,900,000		
Marketable securities			\$2,000,000
Apartment building		\$2,000,000	
Totals	<u>\$2,000,000</u>	<u>\$2,000,000</u>	<u>\$2,000,000</u>

2. When Father and Mother initially formed PPM, LLC:

- They contributed undivided interests in the undeveloped land with a then value of \$800,000 and \$300,000 tax basis (so there was \$500,000 of IRC § 704(c) gain).
- They contributed undivided interests in the apartment building having an aggregate value of \$1,100,000 and tax basis of \$400,000 (so there was \$700,000 of IRC § 704(c) gain).
- Finally, they also contributed marketable securities worth \$1,000,000 having an aggregate basis of \$200,000 (so there was \$800,000 of total Code § 704(c) gain). **Assume that all of the originally contributed securities have been sold so that none of the marketable securities currently held by the LLC were contributed by Parents.**

- d. Assume Parents have died owning no LLC interests so there was no step-up in basis to “purge” any of the pre-contribution gain.
3. The analysis of the liquidation depends upon whether PPM, LLC has been in existence for at least 7 years so as to cause IRC §§ 704(c)(1)(B) and 737 to be inapplicable. First, assume that PPM, LLC has been in existence for at least seven years.
- a. The income tax results of the liquidation are as follows:

	Peter	Paul	Mary
Tax basis – immediately prior to liquidation	\$333,334	\$333,333	\$ 333,333
Less: cash received	<100,000>	-0-	-0-
Less: marketable securities received and treated like cash (see below)	<u>-0-</u>	<u>-0-</u>	<u><\$1,400,000></u>
Remaining basis <Gain>	\$233,334	\$333,333	<\$1,066,667>

- (1) Peter’s tax basis in his member interest is reduced by the \$100,000 of actual cash he receives. The receipt of cash is not taxable because it does not exceed his outside basis. Peter’s basis in the undeveloped land is \$233,334, an amount equal to his remaining basis in PPM, LLC.
- (2) Paul’s basis in the apartment building equals his \$333,333 basis in his member interest. He also recognizes no gain.
- (3) Mary’s basis in the securities needs to be analyzed under IRC § 731(c). The LLC is not an investment partnership, but the limitation contained in IRC § 731(c)(3)(B) causes Mary’s receipt of the securities to be taxed as follows:

Mary’s share of gain attributable to securities held by LLC immediately prior to liquidation [(\$2,000,000 - \$200,000) ÷ 3]	\$600,000
Mary’s share of gain attributable to securities held by LLC immediately after the liquidation	<u>-0-</u>
Reduction in amount treated as cash to Mary	\$600,000
Value of securities distributed to Mary	\$2,000,000
Amount treated as cash	\$1,400,000
Amount treated as property	<u>\$600,000</u>

Therefore, only \$1,400,000 (\$2,000,000 - \$600,000) of the securities received by Mary is treated like cash. Mary recognizes gain of \$ 1,066,667 because her cost basis for her interest in PPM, LLC was \$333,333 and she received cash of \$1,400,000. Mary’s cost basis in the securities is \$1,400,000 (i.e., Mary’s

outside basis of \$333,333 immediately prior to the redemption plus the \$1,066,667 of gain she recognized under IRC § 731(c)). See Treas. Reg. § 1.731-2(f)(1).

4. Now assume that Father and Mother formed the LLC in December of 2012. Seven years have not yet passed and we have to work through the implications of IRC §§ 704(c)(1)(B) and 737. As illustrated below, these assumed facts require the application of the ordering rules described in Section III.B.6 above.

- a. As illustrated below, IRC § 704(c)(1)(B) applies to each of the members due to the “step in the shoes” rule. Each of them is deemed to have contributed 1/3 of the undeveloped land and apartment building received by the others, i.e., properties that their Parents had contributed to the LLC with pre-contribution gain within the previous 7 years. Those amounts are determined as follows:

	Undeveloped Land	Apartment Building	Securities
FMV at date of Parents' contribution	\$ 800,000	\$ 1,100,000	-\$0-
Parents' combined tax basis	<\$300,000>	<\$ 400,000>	<u>-0-</u>
Total pre-contribution gain	\$ 500,000	\$ 700,000	\$ 0
	\div 3	\div 3	\div 3
One third of pre-contribution gain	<u>\$ 166,667</u>	<u>\$ 233,333</u>	<u>-0-</u>

- b. Below is a chart tracking the allocation of the Section 704(c) gain:

	Peter	Paul	Mary
Paul's and Mary's 704(c)(1)(B) gain in respect of the 1/3 interest in the undeveloped land allocated to Peter	\$ 0	\$ 166,667	\$ 166,667
Peter's and Mary's 704(c)(1)(B) gain in respect of the 1/3 interest in the apartment building allocated to Paul	\$ 233,333	\$ 0	\$ 233,333
Total pre-contribution gain recognized	\$ 233,333	\$ 166,667	\$ 400,000

c. Below is a chart tracking the 731(c) gain:

	Peter	Paul	Mary
Securities treated as cash	\$ 0	\$ 0	\$1,400,000 ⁷
Basis before distribution of securities	\$ 566,667	\$ 500,000	\$ 733,333
Total gain	\$ 0	\$ 0	\$ 666,667 [^]

d. Below is a chart tracking the IRC § 737 gain which relates to the distribution of other property to a member due to built-in gains in another property:

	Peter	Paul	Mary
Peter's gain in respect of property (land distributed to Peter for interest in apartment building)	166,667	\$ 0	\$ 0
Paul's gain in respect of property (apartment building distributed to Paul for undeveloped land)	\$ 0	\$ 233,333	\$ 0
Mary's gain in respect of property	\$ 0	\$ 0	\$ 0 ⁸
Total 737 gain	\$ 166,667	\$ 233,333	\$ 0

⁷ Mary's share of gain attributable to the securities held by LLC before distribution
 $[(\$2,000,000 - \$200,000) \div 3]$ \$ 600,000

Mary's share of gain attributable to the securities held by LLC after distribution \$ 0

Amount of distribution not treated like cash \$ 600,000

Amount of distribution treated like cash \$1,400,000

Basis immediately before distribution \$ 733,333

Gain recognized \$ 666,667

⁸ Pursuant to IRC § 704(c)(1)(B)(iii), Mary's outside basis is increased from \$333,333 to \$733,333 as a result of her recognition of \$400,000 of gain under IRC § 704(c)(1)(B). Under the application ordering rules, her gain under IRC § 704(c) is determined prior to her gain under § 731(c). As a result, Mary recognizes additional gain of \$666,667 (\$1,400,000 - \$733,333) upon her receipt of the marketable securities treated as cash under IRC § 731(c).

- (1) Peter's gain is determined as the lesser of:

(A) \$166,667 which is his remaining "pre-contribution gain" inherited from his Parents [\$1,200,000 of pre-contribution gain attributable to the undeveloped land and apartment building \div 3 = \$400,000 (\$400,000 reduced by \$233,333 of 704(c) gain recognized on the distribution of the apartment building to Paul)]; and

(B) \$1,533,333 which is the excess of the other property received (i.e. the \$1,900,000 of property) over his remaining adjusted tax basis of \$466,667 immediately prior to the distribution.⁹

- (2) Paul's gain is determined as the lesser of:

(A) \$233,333 which is his remaining "pre-contribution gain" inherited from his Parents (\$400,000 reduced by his \$166,667 share of the 704(c) gain recognized on the distribution of the land to Peter); and

(B) \$1,500,000 which is the excess of the other property received (i.e. the \$2,000,000 of property) over his remaining adjusted tax basis of \$500,000 immediately prior to the distribution.¹⁰

- (3) Mary's gain is determined as the lesser of

(A) \$0 which is her remaining "pre-contribution gain" inherited from her Parents (\$400,000 reduced by her \$400,000 share of the pre-contribution gain recognized on the distribution of the land and apartment building); and

(B) \$600,000 which is the excess of the other property received (i.e. the \$600,000 of securities not treated as cash) over her remaining adjusted tax basis of \$0 immediately prior to the distribution (\$733,333 but reduced to zero by the receipt of the marketable securities).¹¹

⁹ Pursuant to IRC § 704(c)(1)(B)(iii), Peter's outside basis is increased from \$333,334 to \$566,667 as a result of his recognition of \$233,333 of gain under IRC § 704(c)(1)(B) and decreased by the \$100,000 cash distributed to him, for a net basis of \$466,667.

¹⁰ Pursuant to IRC § 704(c)(1)(B)(iii), Paul's outside basis is increased from \$333,333 to \$500,000 as a result of his recognition of \$166,667 of gain under IRC § 704(c)(1)(B).

¹¹ Pursuant to IRC § 704(c)(1)(B)(iii), Mary's outside basis is increased from \$333,333 to \$733,333 as a result of her recognition of \$400,000 of gain under IRC § 704(c)(1)(B). Mary's basis then was reduced to zero by the distribution of securities she received (see Treas. Reg. §§ 1.731-2(f)(1)(ii) and 1.732-1(b)). This example illustrates a "gap" in the current Treasury Regulations. Treas. Reg. § 1.731-2(f)(1)(ii) provides that the distributee's outside basis is determined under IRC § 733 as if no gain were recognized by the distributee under IRC § 731(c). IRC § 733, however, only deals with the determination of outside basis in the context of non-liquidating distributions. In this case, it is clear that Mary's basis is zero by the time this calculation under IRC § 737 is required to be made. In any event, Mary will have no IRC § 737 gain since, under the applicable ordering rules, she already has recognized her entire \$400,000 share of IRC § 704(c) gain pursuant to IRC § 704(c)(1)(B).

e. Below is a chart showing the total gain recognized:

	Peter	Paul	Mary	Grand Total
Property Received	\$2,000,000	\$2,000,000	\$2,000,000	
Basis before liquidation	\$ 333,334	\$ 333,333	\$ 333,333	
Cash received	<\$ 100,000>	-0-	-0-	
Subtotal	\$ 233,334	\$ 333,333	\$ 333,333	
Section 704(c)(1)(B) gain recognized	<\$233,333>	<\$ 166,667>	<\$ 400,000>	
Gain from distribution of securities treated like cash	-0-	-0-	<\$ 666,667>	
Section 737 Gain Recognized	<\$ 166,667>	<\$ 233,333>	-0-	
Total gain recognized	\$ 400,000	\$ 400,000	\$1,066,667	<u>\$1,866,667</u>
Basis in Property Received	\$ 633,334	\$ 733,333	\$1,400,000	<u>\$2,766,667</u>

Proof:

Fair market value of all LLC assets	\$6,000,000
Less: Total inside basis	< <u>\$1,000,000</u> >
Total unrecognized gain	\$5,000,000
Less: Total gain recognized by the members as a result of the liquidation	< <u>\$1,866,667</u> >
Remaining unrecognized LLC gain – post liquidation	<u>\$3,133,333</u>
Total assets received by members in liquidation	\$6,000,000
Less: Cash received by Peter	< <u>\$ 100,000</u> >
Total non-cash assets received by members	\$5,900,000
Less: Member's aggregate tax basis in assets received	<u>\$2,766,667</u>
Unrecognized gain inherent in property held by members immediately after liquidation	<u>\$3,133,333</u>

V. Redemption of the Interest of a Single Member.

- A. Many times an FLP or FLLC does not liquidate, but instead acquires the interests of one of its owners.
- B. Assume that, rather than liquidating PPM, LLC, Mary asks that her entire interest in the LLC be redeemed since she needs cash.
 1. In order to redeem Mary's interest, PPM, LLC decides that it will have to liquidate a portion of the marketable securities in order to accommodate Mary's request. The LLC agreement probably does not give mandatory redemption rights to a member if it was drafted to maximize valuation discounts to accommodate the initial gifting of the units by the Parents.

2. Assume that when Father and Mother made their gifts of LLC units to their children, they claimed combined lack of marketability and minority interest discounts of 40%. The redemption raises a number of interesting issues, including the following:

- a. Should Mary receive \$2,000,000 of cash for her interest (i.e., one-third of the net fair market value) or should she receive a discounted amount? If so, what discount should apply, i.e., 40% or something less? The answer may lie in the applicable LLC Act. For example, under the Illinois Act, a member of a member-managed LLC can withdraw (“dissociate”) at any time, whether rightfully or wrongfully, and receives “fair value” for his or her interest, less damages, if any, suffered by the LLC or the remaining members. See 805 ILCS §§ 180/35-45 – 180/35-65. In a manager-managed LLC, unless the operating agreement otherwise specifies, a member may not dissociate until the company otherwise dissolves.

Similarly, under the Hawaii Uniform LLC Act, a member of an LLC can, at any time, rightfully or wrongfully, dissociate by express will and receive fair value for his or her interest, less any damages for wrongful dissociation. Haw. Rev. Stat. §§ 428-601 to -703.

In contrast, under the Utah Revised Uniform LLC Act, a person’s dissociation from the LLC does not entitle him or her to a distribution. The LLC may, however, decide to make an interim distribution, but that distribution must be in equal shares among all current members and dissociated members. Utah Code Ann. § 48-3a-404(1), (2). Any transferable interest that the person owned as a member immediately before dissociation is then owned by that person solely as a transferee. Utah Code Ann. § 48-3a-603(1)(c).

- b. If PPM, LLC has to liquidate assets to accommodate Mary, how should that taxable gain (or loss) be allocated among the members?

EXAMPLE 16: Assume PPM, LLC agrees to redeem Mary’s interest for \$2,000,000, using the proceeds from the sale of \$2,000,000 of marketable securities which triggers taxable gain of \$1,800,000. In order to have “substantial economic effect,” the allocations should produce ending capital account balances that equal the liquidating distributions that each member receives for his or her interest. If the allocations are made one-third each, clearly economic effect is not achieved since Mary receives \$2,000,000 in liquidation proceeds but her capital account immediately prior to the distribution would only be \$933,333 (\$333,333 plus one-third of \$1,800,000 gain realized on sale of securities). The distribution will leave Mary with a negative capital account of \$1,066,667 and also leaves Peter and Paul with \$600,000 of taxable gain each. Further, Mary would recognize \$1,066,667 of gain under IRC § 731 since she would be treated as receiving cash in excess of her \$933,333 tax basis in her member interest. Thus, under these facts, in order to get \$2,000,000 of assets to Mary, the members risk triggering an immediate total gain of \$2,866,667.¹²

To avoid this problem, the allocation provisions of the LLC operating agreement should be modified to allocate \$1,666,667 of gain to Mary. Note that Peter and Paul still get “stuck” with phantom gain of \$66,667 each. If this amendment is made, the capital accounts of the members immediately prior to the liquidation are as follows:

¹² Computed as follows: \$1,800,000 gain from the sale of the securities plus the additional \$1,066,667 of gain recognized by Mary under IRC § 731 upon receipt of \$2.0 million in cash.

	Peter	Paul	Mary
Current capital accounts	\$333,333	\$333,333	\$ 333,333
Allocation	<u>\$ 66,667</u>	<u>\$ 66,667</u>	<u>\$1,666,667</u>
Subtotal	<u>\$400,000</u>	<u>\$400,000</u>	<u>\$2,000,000</u>
Less: distribution	<u>-0-</u>	<u>-0-</u>	<u><\$2,000,000></u>
Ending capital accounts	<u>\$400,000</u>	<u>\$400,000</u>	<u>\$ -0-</u>

- c. Because Mary has a tax basis of \$2,000,000 under this revised approach immediately after the special allocation of gain is made to her, she recognizes no further gain (or loss) upon receipt of the redemption proceeds.

EXAMPLE 17: Assume that, under applicable state law and pursuant to the operating agreement of PPM, LLC, Mary has no “right” to withdraw and receive “fair value” for her interest. Nonetheless, assume that the parties negotiate for a 20% discount so that Mary will receive \$1,600,000 of cash in full redemption of her member interest. PPM, LLC sells \$1,600,000 of marketable securities having an aggregate tax basis of \$160,000, triggering \$1,440,000 of taxable gain, in order to effect the redemption and uses the allocation approach set forth in Example 16 above, i.e., Mary is allocated \$1,266,667 of gain in order to build up her capital account to \$1,600,000 immediately prior to the distribution and the balance of the gain is allocated equally to Peter and Paul. Mary’s tax basis is increased to \$1,600,000 so that she does not recognize any additional gain (or loss) upon receipt of the redemption proceeds. When the smoke clears, the balance sheet of PPM, LLC is as follows:

	FMV	Tax Basis
Cash	\$ 100,000	\$100,000
Marketable securities	\$ 400,000	\$ 40,000
Undeveloped land	\$1,900,000	\$300,000
Apartment building	<u>\$2,000,000</u>	<u>\$400,000</u>
Total assets	<u>\$4,400,000</u>	<u>\$840,000</u>
Liabilities	-0-	-0-
Equity:		
Peter	\$2,200,000	\$420,000
Paul	<u>\$2,200,000</u>	<u>\$420,000</u>
	<u>\$4,400,000</u>	<u>\$840,000</u>

- d. Note that Mary’s redemption has caused a \$400,000 capital shift in favor of Peter and Paul (\$200,000 each). While there is not much guidance, arguably the capital shift is non-taxable to Peter and Paul since it is non-compensatory (i.e., not given to them in respect of services rendered to the LLC or to Mary) and is not a gift from their sister (assuming arm’s-length bargaining in connection with the redemption).

I. Tax Free Formation: Section 721(b)

EXAMPLE 1: In January of 2000, Parents formed PPM, LLC by each contributing an undivided interest in real estate worth \$1,900,000, marketable securities worth \$1,000,000, and cash of \$100,000.

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A. Formation of PPM

	FMV	Cost Basis	IRS § 704(c) Gain
Cash	\$ 100,000	\$ 100,000	-0-
Marketable securities	\$ 1,000,000	\$ 200,000	\$ 800,000
Undeveloped land	\$ 800,000	\$ 300,000	\$ 500,000
Apartment building	\$ 1,100,000	\$ 400,000	\$ 700,000
Total assets	\$ 3,000,000	\$ 1,000,000	\$ 2,000,000
Liabilities	-0-	-0-	
Equity:			
Father	\$ 1,500,000	\$ 500,000	\$ 1,000,000
Mother	\$ 1,500,000	\$ 500,000	\$ 1,000,000
Total liabilities and equity	\$ 3,000,000	\$ 1,000,000	\$ 2,000,000

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- Key terms with partnerships and LLCs
 - Inside basis/outside basis
 - Pre-contribution gain
 - Step in the shoes
 - Capital accounts
 - Knowledge of history is critical
 - Contributors of assets and dates of contribution
 - Tax history of each asset
 - Business history of entity

B. Income Tax Issues with Formation

1. Investment Company Issues
 - (a) Gain may be recognized if assets are contributed to an “investment company.”
 - (b) An FLP or FLLC is treated as an investment company if two requirements are met.
 - Diversification
 - Asset test

Asset Test

More than 80% of value is in assets held for investment and are (i) money; (ii) stocks, other corporate equity interests, evidences of indebtedness, options, forward or futures contracts, material principal contracts and derivatives; (iii) interests in regulated investment companies or real estate investment trusts; (iv) foreign currencies; (v) interests in precious metals; (vi) interests in entities substantially all of the assets of which are identified in (i)-(v); and (vii) other assets or entities specified in the Regulations.

EXAMPLE 1: Parents formed PPM, LLC by each contributing an undivided interest in real estate worth \$1,900,000, securities worth \$1,000,000, and cash of \$100,000. PPM, LLC would not be deemed to be an investment company within the meaning of IRC § 721(b) since readily tradeable stocks and securities constitute only one-third of its assets.

EXAMPLE 3: Father has a \$1,000,000 securities portfolio with \$200,000 of stock A, \$50,000 each of stocks B, C, D, E, F, and G, and \$500,000 of numerous government securities (held for a substantial period of time). Daughter also has a \$1,000,000 securities portfolio with \$100,000 each of stocks H, I, J, and K and \$50,000 of twelve other stocks.

- Neither Father nor Daughter has more than 25% of his or her portfolio in any one stock. Father comes closest with 20% in stock A.
- Neither Father nor Daughter has more than 50% of the portfolio in 5 or fewer stocks. Father has 50% in 7 stocks and Daughter has 50% in 6 stocks.
- Father and Daughter will not recognize gain or loss if they contribute their respective portfolios to FLLC.

2. Disguised Sales

The IRS may treat certain contributions to an FLP or FLLC as a disguised sale resulting in gain recognition to the contributing person.

EXAMPLE 5: Assume that Father contributes property with a fair market value of \$100,000 and an adjusted basis of \$40,000 to PPM, LLC. Daughter contributes cash of \$75,000. In order to equalize the contributions of the members, Father receives a cash distribution of \$25,000.

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- Under IRC § 707(a)(2)(B), Father would be treated as selling a 25% undivided interest in the property to Daughter in exchange for the \$25,000 of cash.
 - As a result, Father has a \$15,000 gain computed by subtracting \$10,000 (i.e., one quarter of his \$40,000 basis in the property he contributes) for the property from the \$25,000 of cash received.
 - Father would be deemed to contribute \$75,000 of property with a basis of \$30,000 to PPM, LLC under IRC § 721.
 - Daughter would be deemed to contribute \$50,000 of cash and the \$25,000 interest in the property (with a basis of \$25,000) to PPM, LLC.

FAST-FORWARD A FEW YEARS . . .

- During their lives, Parents give away all of their interests in the LLC – with a 1/3 interest in the LLC going to each of their children, Peter, Paul and Mary.
- After receiving the gifts, each child has an outside basis of \$333,333.
- Parents have since passed away...
- Leaving their children to peacefully co-exist (or not).
- The overall value of the original assets of PPM has doubled.

II. Distribution Issues

	FMV	Tax Basis of Capital Accounts	IRC § 704(c) Gain	Total Unrealized Gain
Cash	\$ 100,000	\$ 100,000	-0-	-0-
Marketable securities	\$ 2,000,000	\$ 200,000	\$ 800,000	\$ 1,800,000
Undeveloped land	\$ 1,900,000	\$ 300,000	\$ 500,000	\$ 1,600,000
Apartment building	\$ 2,000,000	\$ 400,000	\$ 700,000	\$ 1,600,000
Total assets	\$ 6,000,000	\$ 1,000,000	\$ 2,000,000	\$ 5,000,000
Liabilities	-0-	-0-		
Equity: Peter	\$ 2,000,000	\$ 333,334	\$ 666,666	\$ 1,666,666
Paul	\$ 2,000,000	\$ 333,333	\$ 666,667	\$ 1,666,667
Mary	\$ 2,000,000	\$ 333,333	\$ 666,667	\$ 1,666,667
Total liabilities and equity	\$ 6,000,000	\$ 1,000,000	\$ 2,000,000	\$ 5,000,000

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A. Distributions of Cash: Section 731

EXAMPLE 6: Assume that PPM, LLC distributes \$10,000 of cash to each of Peter, Paul and Mary. The members recognize no gain as a result of the distribution, but each party's tax basis in the member interest is reduced by \$10,000. IRC § 731(a)(1).

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B. Distributions of Property

EXAMPLE 7: Assume that, in addition to the \$10,000 of cash distributed to each member, PPM, LLC also distributes an undivided one-third interest in the undeveloped land to each of Peter, Paul and Mary. Assume that the LLC has been in existence for over 7 years.

-
- Each member's tax basis starts at \$333,333. That basis is first reduced by the \$10,000 of cash distributed to \$323,000 (rounded).
 - Next, each member's basis is reduced for the distribution of the land. Because the LLC's tax basis for a one-third interest in the land is \$100,000 ($\$300,000 \div 3 = \$100,000$) which is less than each member's remaining tax basis (\$323,000), each member takes a tax basis in the undeveloped land equal to \$100,000.
 - Each member's basis in his or her interest in the LLC is also reduced by an additional \$100,000 to \$223,000 due to the distribution of the land.
 - See generally IRC § 733.

EXAMPLE 8: Assume Peter sells his undivided interest in undeveloped land for more than \$100,000 one month after the receipt of the property from PPM, LLC, Peter would be entitled to long-term capital gain treatment, provided that PPM, LLC and Peter's Parents held the property for at least an aggregate of 11 months and 1 day.

- IRC §735 generally provides for "tacking" of Peter's holding period.

C. Distributions of Marketable Securities: Investment Partnerships and Section 731(c)

EXAMPLE 9: Because PPM, LLC owns undeveloped land and rental real estate, it probably does not qualify as an investment partnership for purposes of Code § 731(c)(3)(C).

- This wrinkle underscores the need to know the entire "tax history" of the LLC when analyzing the tax consequences of current distributions.

EXAMPLE 10: Each of Peter, Paul and Mary has a cost basis of \$333,333 for his or her interest in PPM, LLC. Assume that PPM, LLC distributes one-half of its marketable securities (worth \$1,000,000 with a cost basis of \$100,000) in equal shares to Peter, Paul and Mary.

- Since the LLC does not qualify as an investment partnership, the distribution must be analyzed under the special limitation rule contained in Code § 731(c)(3)(B).

- **“Before and After” Calculation**

- Member’s 1/3 share of gain attributable to marketable securities prior to distribution
 $[(\$2,000,000 - \$200,000) \div 3]$ \$600,000
- Less: Member’s 1/3 share of gain attributable to remaining marketable securities held by the LLC immediately after the distribution:
 $[(\$1,000,000 - \$100,000) \div 3]$ <\$300,000>
- Amount (per Member) not treated as cash \$300,000
- Amount (per Member) treated as cash \$ 33,333

- **Outside Basis Adjustment**

Each of Peter's, Paul's and Mary's outside basis for his or her interest in the LLC needs to be adjusted.

- Each member's outside basis starts at \$333,333.
- Each of them has received a cash distribution of \$33,333 and a property distribution of \$300,000.
- Because each member has sufficient basis to absorb a deemed cash distribution of \$33,333, the special rules of IRC § 731(c) do not apply and each of their outside basis is reduced by the lesser of (i) the LLC's basis for the assets distributed (\$33,333), and (ii) the member's basis \$333,333.
- Therefore, each of Peter's, Paul's and Mary's outside basis is reduced by \$33,333 to \$300,000 (\$333,333 less \$33,333).



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- **Basis in Securities**

- Each of Peter, Paul and Mary also has a cost basis in the securities received. Because no gain was recognized on the transaction, each has a basis of \$33,333 in the \$333,333 of securities received. See Treas. Reg. § 1.731-2(f)(2).



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EXAMPLE 11: Assume that PPM, LLC distributes one-half of its marketable securities (worth \$1,000,000 with a cost basis of \$100,000) in equal shares to Peter, Paul and Mary. In this case, however, assume that each of Peter, Paul and Mary has a remaining outside basis of only \$23,333 for his or her interest in PPM, LLC.

- Since the LLC does not qualify as an investment partnership, the distribution must be analyzed under the special limitation rule contained in Code § 731(c)(3)(B).

• **“Before and After” Calculation**

– Member’s 1/3 share of gain attributable to marketable securities prior to distribution [(\$2,000,000 - \$200,000) ÷ 3]	\$ 600,000
– Less: Member’s 1/3 share of gain attributable to remaining marketable securities held by the LLC immediately after the distribution: [(\$1,000,000 - \$ 100,000) ÷ 3]	<\$ 300,000>
– Amount (per Member) not treated as Cash	\$ 300,000
– Amount (per Member) treated as cash	\$ 33,333

- **Outside Basis Adjustment**

- Each of Peter's, Paul's and Mary's outside basis for his or her interest in the LLC needs to be adjusted. Each of his or her cost basis starts at \$23,333. Each of them has received a cash distribution of \$ 33,333 and a property distribution of \$300,000.
- In this example, each member has insufficient basis to absorb a cash distribution of \$33,333 (outside basis is only \$23,333), so each will recognize a gain of \$10,000 (\$33,333 less \$23,333) under IRC § 731(a)(1).
- The outside basis for each of their LLC interests is increased by the gain recognized to \$33,333 (\$23,333 plus the \$10,000 gain on the cash distribution of \$33,333).

-
- Additionally, each of them has received a distribution of property worth \$300,000. Each of their outside bases must be reduced by the lesser of (i) the LLC's basis for the assets distributed (\$33,333), and (ii) the member's adjusted basis of \$33,333. As a result, each of their outside bases are reduced to zero as a result of the distribution.
 - Note that the amount of securities distributed but treated as cash does not decrease their outside bases. See Treas. Reg. § 1.731-2(f)(1)(ii).

- **Basis in Securities**

- To the extent that distributed marketable securities are treated as cash, the distributee's tax basis in the securities is increased by the amount of gain recognized on receipt. IRC § 731(c)(4).
- Because gain was recognized on the transaction, each has a basis of \$33,333 in the \$333,333 worth of securities received.

D. Pre-Contribution Gain Issues

EXAMPLE 12: Mother and Son form MS Partnership. Mother contributes cash of \$1,000 and Son contributes Blackacre having a value of \$1,000 although Son's tax basis in the land is only \$400. There is \$600 of built-in gain attributable to Blackacre. Mother and Son share profits and losses on an equal basis.

- If Blackacre is distributed to Mother (who had contributed cash to MS Partnership) within 7 years of the contribution to MS Partnership, Son would recognize the built-in gain of \$600 (assuming that the property had not decreased in value from its \$1,000 date of contribution value). IRC § 704(c)(1)(B).

EXAMPLE 14: Assume MS Partnership used the \$1,000 of cash contributed by Mother to purchase Whiteacre which is distributed to Son within 7 years of the formation of the partnership. Assume that Whiteacre has a value of \$1,000 when it is distributed to Son.

- The distribution causes Son's entire pre-contribution gain of \$600 to be triggered.
- Son's outside basis is increased to \$1,000, i.e., by the \$600 of gain recognized. IRC § 737(c)(1).
- This basis increase is deemed to occur immediately prior to the distribution of Whiteacre.
- When the distribution is deemed to be made, Son's basis in the partnership is reduced by \$1,000 (the partnership's basis in Whiteacre) and he ends up with a \$1,000 basis in Whiteacre.

-
- Ordering Rules: If a distribution results in the application of IRC § 737(c) and one or both of 704(c)(1)(B) and 737 then:
 - 704(c)(1)(B) applies first
 - 731(c) applies next
 - 737 applies last

III. Terminating Distributions

	FMV	Tax Basis of Capital Accounts	Remaining Code § 704(c)	Total Unrealized Gain
Cash	\$ 100,000	\$ 100,000	-0-	
Marketable securities	\$ 2,000,000	\$ 200,000	\$ 800,000	\$ 1,800,000
Undeveloped land	\$ 1,900,000	\$ 300,000	\$ 500,000	\$ 1,600,000
Apartment building	<u>\$ 2,000,000</u>	<u>\$ 400,000</u>	<u>\$ 700,000</u>	<u>\$ 1,600,000</u>
Total assets	<u>\$ 6,000,000</u>	<u>\$ 1,000,000</u>	<u>\$ 2,000,000</u>	<u>\$ 5,000,000</u>
Liabilities	-0-	-0-		
Equity: Peter	\$ 2,000,000	\$ 333,334	\$ 666,666	\$ 1,666,666
Paul	\$ 2,000,000	\$ 333,333	\$ 666,667	\$ 1,666,667
Mary	<u>\$ 2,000,000</u>	<u>\$ 333,333</u>	<u>\$ 666,667</u>	<u>\$ 1,666,667</u>
Total liabilities and equity	<u>\$ 6,000,000</u>	<u>\$ 1,000,000</u>	<u>\$ 2,000,000</u>	<u>\$ 5,000,000</u>

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A. Sell All Assets

All Assets Sold and \$5,000,000 of Gain Recognized (Example 15)

	Peter	Paul	Mary	Total
Cash Distributed	\$2,000,000	\$2,000,000	\$2,000,000	\$6,000,000
Basis immediately prior to sale of assets	\$ 333,334	\$ 333,333	\$ 333,333	\$1,000,000
Plus: Gain allocated due to sale of assets	\$1,666,666	\$1,666,667	\$1,666,667	\$5,000,000
Basis immediately prior to distribution of cash	<u>\$2,000,000</u>	<u>\$2,000,000</u>	<u>\$2,000,000</u>	<u>\$6,000,000</u>
Gain on distribution of cash	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>

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B. Pro Rata In Kind Distribution of Assets

	Peter	Paul	Mary	Total
Fair Market Value of All Assets Distributed	\$2,000,000	\$2,000,000	\$2,000,000	\$6,000,000
Basis immediately prior to liquidation	\$ 333,334	\$ 333,333	\$ 333,333	\$1,000,000
Less: Actual Cash	<\$ 33,334>	<\$ 33,333>	<\$ 33,333>	\$ <100,000>
Basis After Cash	\$ 300,000	\$ 300,000	\$ 300,000	\$ 900,000
Marketable securities treated like cash	<\$ 66,666>	<\$ 66,667>	<\$ 66,667>	\$ <200,000>
Remaining basis	\$ 233,334	\$ 233,333	\$ 233,333	\$ 700,000

In this case, cash and marketable securities have not been distributed in excess of each Member's basis in his or her interest in the LLC.

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Securities Distributions Received \$666,667

The marketable securities treated like cash is determined with regard to the limitation rule contained in Code § 731(c)(3)(B) as follows:

Each member's share of gain attributable to securities held by LLC immediately prior to liquidation \$600,000
 $[(\$2,000,000 - \$200,000) \div 3]$

Each member's share of gain attributable to securities held by LLC immediately after the Liquidation \$ -0-

Securities not treated as cash \$600,000

Securities treated as cash \$ 66,667

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C. Non-Pro Rata Distributions

	Peter	Paul	Mary
Cash	\$ 100,000		
Undeveloped land	\$ 1,900,000		
Marketable securities			\$ 2,000,000
Apartment building		\$ 2,000,000	
Totals	<u>\$ 2,000,000</u>	<u>\$ 2,000,000</u>	<u>\$ 2,000,000</u>

1. Entity in Existence for at Least 7 Years (704(c)(1)(B) and 737 inapplicable)

	Peter	Paul	Mary
Tax basis – immediately prior to liquidation	\$ 333,334	\$ 333,333	\$ 333,333
Less: cash received	<100,000>	-0-	-0-
Less: marketable securities received and treated like cash (see below)	<u>-0-</u>	<u>-0-</u>	<u><\$ 1,400,000></u>
Remaining basis <Gain>	\$ 233,334	\$ 333,333	<\$ 1,066,667>

-
- a. Peter's outside basis is reduced by the \$100,000 of cash he receives. The receipt of cash is not taxable because it does not exceed his outside basis. Peter's basis in the undeveloped land is \$233,334, an amount equal to his remaining basis in PPM, LLC.
 - b. Paul's basis in the apartment building equals his \$333,333 basis in his member interest. He also recognizes no gain.
 - c. Mary's basis in the securities needs to be analyzed under IRC § 731(c). The LLC is not an investment partnership, but the limitation contained in IRC § 731(c)(3)(B) causes Mary's receipt of the securities to be taxed as follows:

COMPUTATION OF MARY'S GAIN

Mary's share of gain attributable to securities held by LLC immediately prior to liquidation $[(\$2,000,000 - \$200,000) \div 3]$	\$ 600,000
Mary's share of gain attributable to securities held by LLC immediately after the liquidation	<u>\$ -0-</u>
Reduction in amount treated as cash to Mary	<u>\$ 600,000</u>
Value of securities distributed to Mary	\$2,000,000
Amount treated as cash	<u><\$1,400,000></u>
Amount treated as property	<u>\$ 600,000</u>

- \$1,400,000 (\$2,000,000 - \$600,000) of the securities received by Mary is treated like cash.
- Mary recognizes gain of \$ 1,066,667 because her cost basis for her interest in PPM, LLC was \$333,333 and she received cash of \$1,400,000.
- Mary's cost basis in the securities is \$1,400,000 (i.e., Mary's outside basis of \$333,333 immediately prior to the redemption plus the \$1,066,667 of gain she recognized under IRC § 731(c)). See Treas. Reg. § 1.731-2(f)(1).

2. Entity in Existence for less than 7 Years (Section 704(c)(1)(B) and 737 applicable)

a. Pre-contribution Gain

	Undeveloped Land	Apartment Building	Securities
FMV at date of Parents' contribution	\$ 800,000	\$ 1,100,000	-\$0-
Parents' combined tax basis	<\$300,000>	<\$400,000>	-\$0-
Total pre-contribution gain	\$ 500,000	\$ 700,000	\$ 0
	÷ 3	÷ 3	÷ 3
One-third of pre-contribution gain	\$ 166,667	\$ 233,333	-\$0-

- Unlike IRC § 731(c), Donees step into the shoes of the Donors for these purposes.

b. Triggering of 704(c) Gain

	Peter	Paul	Mary
Paul's and Mary's 704(c)(1)(B) gain in respect of the 1/3 interest in the undeveloped land allocated to Peter	\$ 0	\$ 166,667	\$ 166,667
Peter's and Mary's 704(c)(1)(B) gain in respect of the 1/3 interest in the apartment building allocated to Paul	\$ 233,333	\$ 0	\$ 233,333
Total pre-contribution gain recognized	\$ 233,333	\$ 166,667	\$ 400,000

c. 731(c) Gain

	Peter	Paul	Mary
Securities treated as cash	\$ 0	\$ 0	\$ 1,400,000
Basis before distribution of securities	\$ 566,666	\$ 500,000	\$ 733,333
Total Gain	\$ 0	\$ 0	<u>\$ 666,667</u>
Total pre-contribution gain Recognized	\$ 233,333	\$ 166,667	\$ 400,000

d. Section 737 Gain

	Peter	Paul	Mary
Peter's gain in respect of property (land distributed to Peter for interest in apartment building)	\$ 166,667	\$ 0	\$ 0
Paul's gain in respect of property (apartment building distributed to Paul for undeveloped land)	\$ 0	\$ 233,333	\$ 0
Mary's gain in respect of property	\$ 0	\$ 0	\$ 0
Total 737 gain	\$ 166,667	\$ 233,333	\$ 0

e. Summary

	Peter	Paul	Mary	Grand Total
Property Received	\$ 2,000,000	\$ 2,000,000	\$ 2,000,000	
Basis before liquidation	\$ 333,334	\$ 333,333	\$ 333,333	
Cash received	<\$ 100,000>	-0-	-0-	
Subtotal	\$ 233,334	\$ 333,333	\$ 333,333	
Section 704(c)(1)(B) gain recognized	<\$ 233,333>	<\$ 166,667>	<\$ 400,000>	
Gain from distribution of securities treated like cash	-0-	-0-	<\$ 666,667>	
Section 737 Gain Recognized	<\$ 166,667>	<\$ 233,333>	-0-	
Total gain recognized	\$ 400,000	\$ 400,000	\$ 1,066,667	<u>\$ 1,866,667</u>
Basis in Property Received	\$ 633,334	\$ 733,333	\$ 1,400,000	<u>\$ 2,766,667</u>

f. Cross Check

• Fair market value of all LLC assets	\$6,000,000
• Less: Total inside basis	< \$1,000,000 >
• Total unrecognized gain	\$5,000,000
• Less: Total gain recognized by the members as a result of the liquidation	< \$1,866,667 >
• Remaining unrecognized LLC gain – post liquidation	<u>\$3,133,333</u>
• Total assets received by members in liquidation	\$6,000,000
• Less: Cash received by Peter	< \$ 100,000 >
• Total non-cash assets received by members	\$5,900,000
• Less: Member's aggregate tax basis in assets received	<u>\$2,766,667</u>
• Unrecognized gain inherent in property held by members immediately after liquidation	<u>\$3,133,333</u>

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IV. Partial Liquidation

A. Gain Triggered on Redemption

EXAMPLE 16: Assume PPM, LLC agrees to redeem Mary's interest for \$2,000,000, using the proceeds from the sale of \$2,000,000 of marketable securities which triggers taxable gain of \$1,800,000.

- In order to have "substantial economic effect," the allocations should produce ending capital account balances that equal the liquidating distributions that each member receives for his or her interest.
- If the allocations are made one-third each, clearly economic effect is not achieved since Mary receives \$2,000,000 in liquidation proceeds but her capital account immediately prior to the distribution would only be \$933,333 (\$333,333 plus 1/3 of \$1,800,000 gain realized on sale of securities).

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- The distribution will leave Mary with a negative capital account of \$1,066,667 (\$2,000,000 less \$933,333) and also leaves Peter and Paul with \$600,000 of taxable gain each.
- Further, Mary would recognize \$1,066,667 of gain under IRC § 731 since she would be receiving cash in excess of her \$933,333 tax basis in her member interest.
- Thus, under these facts, in order to get \$2,000,000 of assets to Mary, the members risk triggering an immediate total gain of \$2,866,667.

B. Special Allocations

To avoid this problem, the allocation provisions of the LLC operating agreement should be modified to specially allocate \$1,666,667 of gain to Mary. Peter and Paul still get “stuck” with phantom gain of \$66,667 each. If this amendment is made, the capital accounts of the members immediately prior to the liquidation are as follows

	Peter	Paul	Mary
Current capital accounts	\$ 333,333	\$ 333,333	\$ 333,333
Allocation	\$ 66,667	\$ 66,667	\$ 1,666,667
Subtotal	\$ 400,000	\$ 400,000	\$ 2,000,000
Less: distribution	-0-	-0-	<\$2,000,000>
Ending capital accounts	\$ 400,000	\$ 400,000	\$ -0-

C. Discounts on Redemption

EXAMPLE 17: Assume that, under applicable state law and the operating agreement of PPM, LLC, Mary has no “right” to withdraw and receive “fair value” for her interest. Nonetheless, assume that the parties negotiate for a 20% discount so that Mary will receive \$1,600,000 of cash in full redemption of her member interest.

- PPM, LLC sells \$1,600,000 of marketable securities with a tax basis of \$160,000, triggering \$1,440,000 of taxable gain.
- PPM uses the allocation approach set forth in Example 10 above. Mary is allocated \$1,266,667 of gain in order to build up her capital account to \$1,600,000 immediately prior to the distribution. The balance of the gain is allocated equally to Peter and Paul.
- Mary's tax basis is increased to \$1,600,000. She does not recognize any additional gain (or loss) upon receipt of the redemption proceeds.



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When the smoke clears, the balance sheet of PPM, LLC is as follows:

	FMV	Tax Basis
Cash	\$ 100,000	\$100,000
Marketable securities	\$ 400,000	\$ 40,000
Undeveloped land	\$1,900,000	\$300,000
Apartment building	<u>\$2,000,000</u>	<u>\$400,000</u>
Total assets	<u>\$4,400,000</u>	<u>\$840,000</u>
Liabilities	-0-	-0-
Equity:		
Peter	\$2,200,000	\$420,000
Paul	<u>\$2,200,000</u>	<u>\$420,000</u>
	<u>\$4,400,000</u>	<u>\$840,000</u>



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