TCJA May Spur Liquidations Of Family Limited Partnerships

by Jonathan Curry

Taxpayers who set up family limited partnerships for the potential estate tax savings may find that the much higher estate tax exemption levels nullify that purpose, but liquidating those entities raises complex tax considerations.

Making gifts sometimes means forgoing a basis step-up, and if a taxpayer no longer has to worry about the estate tax because of the Tax Cuts and Jobs Act's (P.L. 115-97) doubled estate and gift tax exemption, they no longer save on estate tax and they lose on the income tax side, Gary A. Zwick of Walter Haverfield LLP said June 12 at an American Institute of CPAs conference in Las Vegas. "So the combination of those could make a family partnership disadvantageous," he said.

FLPs are often formed for tax reasons, especially for wealthy individuals who want to make gifts yet still retain control, Zwick said. He explained that typically, the taxpayer would form a partnership, make themselves a general partner, and then give away assets like land while also receiving liquidity discounts that could lower their eventual estate tax liability.

There are also nontax reasons for FLPs, like making it easier to transfer family assets to family members or out of the probate estate, Zwick said. Ordinarily, making a gift of an asset like land would require extensive documentation to draw up as well as signatures from multiple parties, whereas if the land is in a partnership, a simple letter of assignment is sufficient. "You sign it, it's over, that's great, it's easy. You can do that in a couple of minutes," Zwick said. FLPs also provide asset protection from creditors and in divorces, which is "very appealing," he added.

Nevertheless, there are several reasons why a taxpayer might want to dissolve the partnership, Zwick said. "A lot of people don't want to be dying with that partnership interest that might be discounted in their estate and not get the full basis step-up." Perhaps their situation has changed and the asset protection features are unnecessary, or, more frequently, there's a family feud because of differing views over how to handle the assets, he said.

If a family decides to dissolve the partnership, they must be aware of several potential tax traps, Zwick said. Section 731 says that distributions of property from a partnership to a partner are tax free, and the property "takes the same basis you had in your partnership interest, and your holding period is the same as your partnership interest," he explained.

"So we should be done — but that's only a general rule," Zwick said. There's an exception for distributions of cash and marketable securities in excess of basis, which are treated as income. Likewise, if the taxpayer is relieved of any liability within the partnership, that's also considered a cash distribution, he said.

But the taxpayer can avoid triggering tax through section 731 if the partnership is an investment partnership and the distribution is made to an eligible party, Zwick said. The challenge there is that the partnership must have contained exclusively cash or marketable securities "every minute of every day of this partnership — so keep hoarding those tax returns," Zwick said. Tax under section 731 can also be avoided outside an investment partnership if the property is distributed back to the same partner who contributed it, he said, adding, "You may still have a distribution in excess of basis . . . but it's not a distribution of cash."

Zwick said tax planners should be aware of sections 704 and 737 to avoid having a transaction deemed a disguised sale. If a partner contributes property and gets different property back within seven years, it's deemed a disguised sale and treated as if the contributing partner had sold it at full market value on the date of the distribution. Waiting seven years from the last property contribution is a "good rule" to follow, he added.

"So the moral of the story is you want to keep these together because they have a lot of nontax benefits. But if you've got to tear them down, try to make [the partners] take pro rata distributions more than seven years after the property was contributed," Zwick said. ■