

THE TAX AND NON-TAX PITFALLS OF LIQUIDATING A BUSINESS

Moderator

**JASON A.
MARSH**

**GREEN &
SKLARZ LLC**

Panelist

**J. ROBERT
TURNIPSEED**

**ARMBRECHT
JACKSON LLP**

Panelist

**ROBERT M.
FINKEL, ESQ.**

**MORITT
HOCK &
HAMROFF LLP**

IRS REPRESENTATION CONFERENCE | NOVEMBER 18, 2022 | OMNI HOTEL, NEW HAVEN,
CONNECTICUT

1

OVERVIEW

- NON-TAX CONSIDERATIONS
- PRACTICAL TAX ISSUES AND FILINGS
- TAX IMPLICATIONS OF LIQUIDATIONS
- REAL WORLD APPLICATION
- QUESTIONS AND OVERFLOW

2

BUSINESS LIQUIDATION HYPOTHETICAL

- C CORPORATION EXAMPLE
- Chompers Inc. is owned by Bob (50%), Sue (26%), and Pat (24%). Chompers is a C-Corp.
- Pat invented a “Wonder Widget” that has made Chompers a successful company.
- Chompers owns the trademarks, patents, and all related IP regarding Wonder Widget, which were assigned to it by Pat. Pat signed both a non-compete and shareholder agreement that prohibits him from competing with the business or soliciting customers upon termination or sale of shares.
- Company was successful for 20 years, until a competitor developed a new “wonder widget” that took over the market, significantly reducing profits.
- Shareholder’s basis in stock--\$200,000 for Bob, \$100,000 for Sue, (value of land and certain cash contributions), but unknown for Pat (never calculated value of capital contributions)

3

BUSINESS LIQUIDATION HYPOTHETICAL

- Company has very little debt (less than \$100,000) and owns the following assets:
 - Factory and Land (value \$2.5 million, land was contributed by Bob and Sue, 20 years of depreciation)
 - Cash (\$500,000)
 - Equipment and office furniture (\$1 million, fully depreciated)
 - Accounts Receivable (\$500,000)
 - Promissory Note from Pat (remaining debt \$250,000)
 - Inventory (\$1 million)
 - IP/Goodwill (unknown value)

4

BUSINESS LIQUIDATION HYPOTHETICAL

Questions from the Hypothetical

1. What is the tax effect of liquidation if Chompers is a C Corporation? S Corporation? LLC?
2. How is the goodwill and IP taxed? What if Pat never assigned the trademarks and patents, and did not sign a non-compete or shareholder agreement?
3. Any tax issues relating to the contributed property by shareholders? What if it was an S Corp? LLC?
4. How will the debt of the company be handled at liquidation? Tax implications?
5. Tax effect of distribution of Accounts Receivable? Promissory Note?
6. How should the inventory be distributed in liquidation?
7. What are the practical considerations of the liquidation? Notifications? Tax filings? Method of winding up? Gathering of information?

5

NON-TAX CONSIDERATIONS

Causes for Business Terminations:

- Unprofitability / Lack of capital.
- Loss of major customer(s).
- Protection from creditors.
- Business competition.
- Declining demand for goods or services.
- Lack of qualified labor.
- Operational inefficiencies, such as overpaying for:
 - labor;
 - rent; or
 - utilities.
- Shareholder disputes.
- One or more shareholders experiencing:
 - illness;
 - death; or
 - retirement.

6

PRELIMINARY CONSIDERATIONS

Preliminary Considerations:

Before closing down its business, a company should consider many issues:

- Hire and consult with professionals:
 - an attorney;
 - an accountant;
 - a business valuation expert; and
 - a public relations or corporate communications specialist.

7

PRELIMINARY CONSIDERATIONS

Preliminary Considerations:

Are there any viable alternatives to closing down the business, such as selling it:

- to one or more shareholders;
- to one or more unaffiliated third parties
 - Competitor
 - Vendor / private equity;
 - Customer; or
 - through an auction.
- Can the business be split up between the owners?
- Can a business be merged with another entity?

8

PRELIMINARY CONSIDERATIONS

Preliminary Considerations:

- Any consents required before closing down the business? For example, most loan agreements restrict the borrower's ability to enter into any fundamental transactions, including:
 - mergers;
 - consolidations;
 - sales of substantially all of the borrower's assets; or
 - liquidations.

9

PRELIMINARY CONSIDERATIONS

Preliminary Considerations:

- Any potential payment obligations that may be triggered by the business closure, such as:
 - bank loan acceleration;
 - multiemployer pension plan withdrawal liability;
 - golden parachute payments; or
 - other payments under executive employment agreements.

10

PRELIMINARY CONSIDERATIONS

Preliminary Considerations:

- Consider labor and employment issues, including:
 - whether it needs any employees while it is winding down; and
 - if and when it needs to conduct layoffs; and
 - Are there any employment agreements with change of control or other provisions that would require payments?

11

PRELIMINARY CONSIDERATIONS

Preliminary Considerations:

- Analyze the tax consequences of:
 - the business closure; and
 - any alternatives to the business closure.

12

STEPS TO LIQUIDATION

Liquidation is usually a long term, multi-step process, which should be focused on resolving disputes, paying down debt and preserving value for transfers to the shareholders. It involves the following:

- Set a timetable for completing all steps related to the business closure.
- Develop a public relations and corporate communications plan to announce the business closure to constituents both inside and outside the company.
- Prepare a list of all creditors.

13

STEPS TO LIQUIDATION

- Prepare an asset inventory with values, including:
 - cash;
 - financial accounts;
 - pre-paid expenses;
 - contracts;
 - real estate;
 - buildings;
 - fixtures;
 - equipment;
 - inventory;
 - office furniture;
 - computers;
 - vehicles; and
 - intellectual property.

14

STEPS TO LIQUIDATION

- Obtain a business valuation report to assist with the sale or transfer of company assets.
- Consider the implications on executory commercial contracts.
- Decide what business records and other data must be retained, for how long, who will retain custody, and where the information will be stored because audits, tax returns, and lawsuits against a company often occur after a business closure.
- Open a reserve account, which remains open after the business technically closes to:
 - facilitate creditor payment; and
 - cover other costs associated with the business closure.

15

TERMINATION OF THE LEGAL ENTITY

▪ Terminate the Existence of the Company's Legal Entity

When closing down its business, a company must terminate the existence of its legal entity. For example, termination of the existence of a Delaware corporation involves:

- Corporate Action to Dissolve which must be approved by either:
 - a resolution approved by a majority of the board of directors followed by a notice to, and approval of, a majority of the outstanding stock of the corporation entitled to vote on that matter; or
 - the unanimous consent of all of the shareholders entitled to vote on that matter, with no prior action by the board.
- File Formal Certificate of Dissolution. Once the decision to dissolve a corporation is properly authorized, a certificate of dissolution must be filed with the Secretary of State.

16

TERMINATION OF THE LEGAL ENTITY

- **Terminate the Existence of the Company's Legal Entity**
- Dissolving a Delaware limited liability company follows some of the same steps as dissolving a corporation.
- Depending on its state of incorporation, a corporation is not deemed dissolved until all franchise taxes are paid. In most states, a corporation also must obtain a tax clearance certificate. The procedure for and timing of an application for a tax clearance certificate varies from state to state.

17

WINDING UP THE COMPANY'S BUSINESS AFFAIRS

Wind Up the Company's Business Affairs

After completing the steps necessary for dissolution, a company must:

- Cease conducting all business operations.
- Wind up its business affairs.

Winding up a company's business affairs involves:

- Notifying all creditors by providing them with:
 - actual notice of the business closure; and
 - notice by publication in a newspaper, if required under state law.
- Settling with creditors by:
 - paying off debts; or
 - making other provision for their payment.

18

WINDING UP THE COMPANY'S BUSINESS AFFAIRS

Wind Up the Company's Business Affairs

- Assigning or terminating commercial contracts
- Notifying suppliers, customers, and other parties in the commercial supply chain.
- Terminating all manufacturing, production, distribution, and sales of goods and services.
- Conducting layoffs, if the company has employees
- Informing insurance and utilities companies.
- Requesting refunds of pre-paid expenses, such as insurance premiums, if permitted.

19

WINDING UP THE COMPANY'S BUSINESS AFFAIRS

Wind Up the Company's Business Affairs

- Collecting outstanding accounts receivable and other monies owed to the company.
- Cancelling business permits and licenses.
- Terminating registration of fictitious business names.
- Taking possession of all company assets in the possession of contract partners and others.
- Selling or distributing:
 - all inventory and complying with bulk sales laws; and
 - other assets, such as real estate and IP.

20

WINDING UP THE COMPANY'S BUSINESS AFFAIRS

Wind Up the Company's Business Affairs

- Securely disposing of records and other data, such as personally identifiable information (PII) as well as equipment and other media where they may reside, in accordance with:
 - federal, state, and local law;
 - privacy policies; and
 - contracts.
- Shutting down the company's website and social media accounts and archiving copies for legal defense purposes.
- Closing financial accounts, except a reserve account created to pay continuing company liabilities.
- Filing final tax returns

21

LIQUIDATING DISTRIBUTIONS

Liquidating Distributions.

After paying off its creditors during the winding up process, a company must:

- Distribute any remaining assets to its shareholders by:
 - paying them cash;
 - assignment;
 - bill of sale; or
 - deed.
- Collect and cancel all stock certificates.
- Provide shareholders with a statement of the fair market value of any assets transferred or distributed to each for use in preparing their personal income tax returns.

22

CONTRACT CONSIDERATIONS

Commercial Contracts Considerations

Winding up a company's business affairs involves commercial contracts considerations, including:

- Assigning contractual rights.
- Delegating contractual performance obligations.
- Terminating contracts.

23

CONTRACT CONSIDERATIONS

Contract Transfer

- When assigning rights or delegating performance, the transferor must look to applicable law and the contract's express language to determine whether it can validly complete the intended transfer without obtaining the non-transferring party's consent. If consent is required and not obtained, the transferor risks:
 - breaching the contract; and
 - making an ineffective and invalid transfer.
- When a party assigns contractual rights or delegates contractual duties to another party, the parties commonly enter into an assignment and assumption agreement.
- After a contract is transferred, the transferee generally provides notice to the non-assigning or non-delegating party to the contract.

24

CONTRACT CONSIDERATIONS

Contract Termination

- If a company decides not to transfer an agreement, it may terminate it by exercising:
 - Rights granted under applicable statutory or common law.
 - An express contractual right of termination.
- If a company unilaterally terminates an agreement before completion of performance, it should send the non-terminating party a notice of termination.
- If the parties mutually agree to terminate an agreement, they should execute a separate termination agreement to:
 - Set the termination date.
 - Outline the terms and conditions of termination.
 - Release all claims and liabilities of the parties relating to the terminated agreement (if appropriate).

25

REAL ESTATE CONSIDERATIONS

Real Estate Considerations

- Winding up a company's business affairs often involves real estate considerations, including:
 - Selling real estate
 - Assigning leases.
 - Subleasing. If subleasing, a company should ensure that the original lease term expires before its dissolution, otherwise the remaining shareholders may still be held liable for the lease's obligations.

26

REAL ESTATE CONSIDERATIONS

Real Estate Considerations

- Many leases contain an express provision prohibiting a tenant's right to enter into a lease assignment or sublease without first obtaining prior consent from the:
 - Landlord.
 - Landlord's lender.
 - Ground lessor, if there is a ground lease in place.

27

IP CONSIDERATIONS

IP Considerations

- When winding up its business affairs, a company may sell and assign its:
 - Patents.
 - Copyrights.
 - Trade secrets.
- If a company owns trademarks, however, they may only be assigned together with the goodwill of the business associated with the marks.

28

IP CONSIDERATIONS

IP Considerations

- When a business closes, its goodwill ends. As a result, a trademark assignment made by a closing business is deemed ineffective and the trademark may become abandoned, unless the assignment is accompanied by a sale or transfer to the assignee of business or tangible assets associated with the mark's use.
- If a company determines that it will not receive appreciable value from the sale and assignment of IP registrations and applications, it may allow them to become abandoned by not:
 - Paying maintenance or renewal fees.
 - Meeting maintenance or renewal deadlines.
- Trademarks are presumed abandoned after three consecutive years of nonuse.

29

IP CONSIDERATIONS

IP Considerations

- When closing down a business, the transferability of IP license agreements requires special consideration because a licensee's rights are generally not assignable unless:
 - The license agreement expressly permits assignment.
 - The licensor otherwise consents.

30

HANDLING LAYOFFS OF EMPLOYEES

Conduct Layoffs

- When a company has employees, closing down its business eventually leads to a reduction in force or layoff. A company may terminate employees at will unless prohibited by individual employment agreements, a collective bargaining agreement (CBA), or state statute.
- Before conducting layoffs, the company should evaluate whether there are employees that may be essential to closing down the business and consider entering retention agreements for the period their services will be necessary
- Under a severance policy, a company may be required to or voluntarily choose to offer severance benefits to terminated employees

31

HANDLING LAYOFFS OF EMPLOYEES

Conduct Layoffs

- For example, executive employment agreements often provide for payment of severance and other benefits in the event of termination in certain circumstances. Additionally, if a company has a policy or practice of providing severance benefits to at-will employees who are laid off, it should comply with that policy or practice.
- Employers who withdraw from a multiemployer pension plan are liable for a portion of the plan's unfunded vested liabilities and must pay withdrawal liability to the plan.
- When implementing layoffs, in many cases, a company that employs at least 20 employees also must offer terminated employees and their dependents the opportunity to continue their health plan coverage, and information about this election opportunity, as required by the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA)

32

HANDLING LAYOFFS OF EMPLOYEES

Conduct Layoffs

- Depending on the size of a layoff, a company may need to comply with notice and other requirements under the federal Worker Adjustment and Retraining Notification Act (WARN Act). The WARN Act requires covered employers with 100 or more employees to provide at least 60 days advance notice before a plant closing or a mass layoff.
- Some states have enacted their own versions of the federal WARN Act, also known as mini-WARN Acts. If a layoff takes place in one of these states, a company also must comply with the state's mini-WARN Act. Layoffs in unionized facilities can present additional concerns, as they can trigger obligations:
 - Under existing CBAs.
 - To bargain with the union over the contemplated decision and its effects.

33

PRACTICAL TAX ISSUES AND FILINGS

Practical Tax Issues

When closing down its business, there are several tax issues that a company must address, including:

- Obtaining a tax clearance certificate, in those states where applicable.
- Reporting the dissolution to federal, state, and local tax authorities. For example, to notify the Internal Revenue Service (IRS) of a corporate dissolution, a company must file IRS Form 966 within 30 days after the resolution or plan to dissolve the corporation is adopted.

34

PRACTICAL TAX ISSUES AND FILINGS

Practical Tax Issues

- If a company has employees:
 - issuing final wage and withholding information to them (IRS Form W-2s);
 - reporting information from IRS Form W-2s issued;
 - filing compliant IRS information reporting forms and distributing corresponding employee statements regarding health coverage, as required under the Affordable Care Act (ACA)
 - filing the final employee benefit plan Form 5500;
 - filing the final employment tax return and attaching a statement sharing the name of the person keeping the payroll records and the address where the records will be kept; and
 - making final deposits of employment taxes.

35

PRACTICAL TAX ISSUES AND FILINGS

Practical Tax Issues

- If a company uses independent contractors:
 - issuing final payment information to them (IRS Form 1099); and
 - reporting information from IRS Form 1099s issued.
- Filing final federal, state, and local tax returns for the year the business closes.
- Paying final taxes.
- If a company has qualified retirement plans, a decision must be made whether to terminate the plans.
- In addition to required company tax filings that must be made, shareholders of a dissolved standalone corporation must report any capital gains or losses related to the receipt of any cash or property on their personal income tax returns.

36

TAX IMPLICATIONS OF LIQUIDATION

Tax issues in liquidation depend on a few major issues, including the following:

- Type of Entity
- Types of Assets
- Form of liquidation transaction
- Distribution of property v. Sale and Distribution of Cash

37

TAX TREATMENT TO CORPORATION

- **General Rule under Section 336 – gain or loss recognized by liquidating corporation on distribution of property to shareholders in complete liquidation as if property sold for fair market value. § 336(a)**
- Liabilities distributed? The fair market value of the property distributed is not less than any liabilities distributed. § 336(b)
- General rule does not apply to distributions for reorganizations. § 336(c)
- Related Party rules—no losses recognized by corporation for distributions to related parties under Section 267 if
 - Distribution is not pro rata; and
 - Property is disqualified property.
- Disqualified property? Defined in § 336(d)(1)(B)

38

TAX TREATMENT TO SHAREHOLDER

- **General Rule under Section 331** – gain or loss recognized by shareholder receipt of property from liquidating basis. Treated as exchange of stock for property.
- Calculated by subtracting shareholder's basis in stock from FMV of the property received from corporation.
- Liabilities distributed? Subtract any liabilities assumed by shareholder from the amount realized.
- Related party rules? Inapplicable to complete liquidations under Section 267(a)(1).
- Basis? Typically fair market value of the assets distributed. § 334(a).

39

INSTALLMENT PAYMENTS

Section 346(a)—plan of liquidation

- No technical requirement for a plan of liquidation under Section 331 in order for shareholder to receive capital gains treatment on liquidation proceeds.
- But if payments are to be made over years, Section 346(a) states that a series of distributions will be treated as having been made in complete liquidation if “pursuant to a plan.”
- Regulations and rulings? Regulations have not been amended since statute amended, and IRS will not issue PLRs where distributions in liquidation to be made over a period longer than three years.

40

LIQUIDATION OF SUBSIDIARIES—SECTION 332

- Can result in non-recognition treatment under Section 332 and 337.
- Requirements for non-recognition:
 - Parent corporation owns more than 80% of stock of subsidiary on date of adoption of plan of liquidation, and at all times until receipt of property; and
 - Distribution was in complete cancellation of all stock of liquidating corporation; and
 - Distribution occurs within the taxable year; OR
 - Distribution part of a series of distributions in complete cancellation of stock under plan to be concluded within three years from close of taxable year in which first distribution made.

41

TAX TREATMENT OF S CORPORATION LIQUIDATIONS

- **To the Shareholder:** Section 331 applies. Treated as sale of stock for property. Capital gain or loss.
 - Again, subtract any liabilities received from amount realized.
 - Because this is considered payment for stock, Section 1368 distribution rules do not apply (so no netting of AAA on distribution).
- **To the Corporation:** Section 336 applies to tax the distribution, but not taxed as corporate level. Shareholder pays no additional tax at the shareholder level, because shareholder basis in stock is increased by amount of taxes paid. § 1367
 - Per Section 1368, Shareholder can use increased stock basis to offset any gain of corporation from deemed sale that would otherwise flow through to Shareholder.

42

TAX TREATMENT OF S CORPORATION LIQUIDATIONS

Built in Gains Tax

- BIG tax imposed at highest corporate tax rate on disposition of any asset on hand at time S election was made.
- Can also apply to assets transferred from another corporation in a substitute basis transaction.
- BIG tax inapplicable for the following:
 - Corporation was never a C corporation;
 - Corporation has no net unrealized built in gain on date of S Election;
 - Corporation has previously recognized built in gains equal to net unrealized built in gain on date of S election; or
 - Recognition period (5 years) from date of S election has expired, and no outstanding payments from installment sales that originated before or during the five year period.

43

TAX TREATMENT OF S CORPORATION LIQUIDATIONS

- **Handling pass-through items in the year of liquidation—Section 1366(a)**
 - Liquidating S Corp year ends on date it ceases to exist.
 - Shareholders should include pro rata shares of income in year when S Corp liquidates.
 - For fiscal year S Corps, this can result in bunching of income in year of liquidation, i.e., paying taxes on ending of fiscal year, and then paying taxes on the short year when S Corp ceases to exist.

44

DISTRIBUTION OF PROPERTY FROM CORPORATIONS

- **Code Section 1239**

- Re-characterizes gain from the sale or exchange of depreciable or amortizable property between related parties as ordinary income.
- A related party with respect to a person includes a “controlled entity” which includes any corporation in which the person owns more than 50% of the outstanding stock.
- Constructive ownership rules apply from Section 267(c), meaning that stock of “family members” will be attributed to stockholder.

NOTE: the recapture provisions of Section 1250 also apply in a liquidation of a corporation for any distributions of depreciable property.

45

DISTRIBUTION OF PROPERTY FROM CORPORATIONS

Issues with Intangible Goodwill—Personal or Corporate?

- Distribution of corporate goodwill taxable in liquidation, just like any other asset.
- **Martin Ice Cream Co. Case**—goodwill was personal and belonged to the shareholder in a Section 355 split off transaction. No “saleable” goodwill where company was dependent on key employees, unless employees enter a covenant not to compete with the company or other agreement where personal s the relationships with clients become property of the corporation.
- Major question—did Corporation distribute goodwill to shareholders upon liquidation? What is the value of the goodwill distributed?
- What happens if Corporation cancels non-competes in the year prior to liquidation? Does that avoid taxation of goodwill upon liquidation?

46

ALTERNATIVES TO LIQUIDATION

What are the alternatives to liquidation?

- Sale to third party (similar tax issues)
- Reorganization under Section 368
- Corporate Division under [Code Section 355](#)

47

TAX-FREE CORPORATE DIVISIONS—SECTION 355

[IRC § 355](#) allows for tax-free divisions of corporations. There are seven requirements for Section 355 to apply.

- **Distribution is made to a shareholder with respect to the shareholder's stock of the distributing corporation**
 - Spin-off
 - Split-off
 - Split-up
- **Distributing corporation must distribute stock of "controlled corporation" which controls immediately prior to distribution**
 - Must own at least 80% of voting stock and 80% of all other classes prior to distribution
 - If distributing corporation retains any stock in controlled corporation must demonstrate retention is not for tax avoidance purposes

48

TAX-FREE CORPORATE DIVISIONS

- **Transaction cannot be principally as a device to distribute earnings and profits**
 - IRS will look at number of device and non-device factors post-distribution.
- **Active business test**
 - Active conduct of trade or business by distributing corporation or a controlled corporation
 - Active trade or business is defined as certain activities which excludes holding certain investment assets unless owner performs substantial personal services
 - Active business must have been conducted for 5 year period prior to distribution
 - Control of corporation engaged in active business cannot have been acquired in taxable transaction within 5 year period

49

TAX-FREE CORPORATE DIVISIONS

- **Transaction must have a business purpose**
 - Must be a real and substantial non-federal tax purpose
 - Requirement stems from case law, specifically [Gregory v. Helvering, 293 U.S. 465 \(1935\)](#), and now contained in regulations.
 - As of 2003, IRS will not issue PLR's on business purposes
 - However, PLR's prior to 2003 are instructive
 - A shareholder purpose is not same as corporate purpose, but shareholder dispute may qualify
 - Dispute must involve shareholders actively involved in running of business
 - Disputes among passive shareholders will not qualify

50

TAX-FREE CORPORATE DIVISIONS

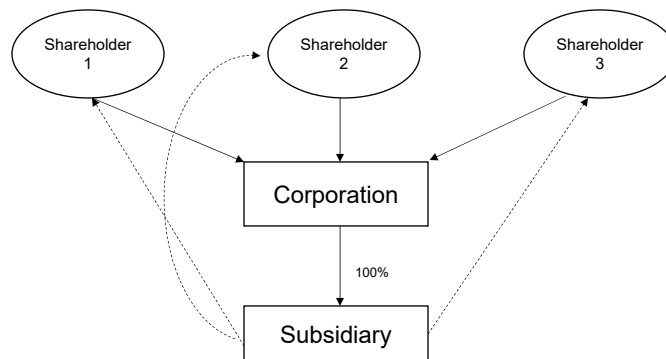
- **Continuity of interest**
 - One or more shareholders of distributing corporation should own continuing interest in distributing corporation and controlled corporation after distribution
 - 50% should be enough [Reg. § 1.355-2\(c\)\(2\)](#)

- **Active trade or business which existed five years before the spin-off must exist after the spin-off**

51

SPIN-OFF

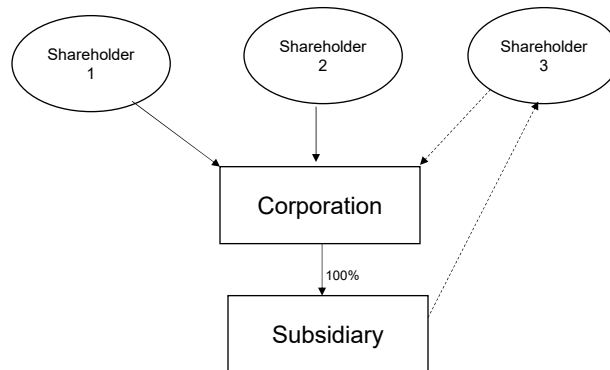
A spin-off usually involves the distributing corporation making a pro-rata distribution of the stock of an existing or newly-formed subsidiary to its shareholders



52

SPLIT-OFF

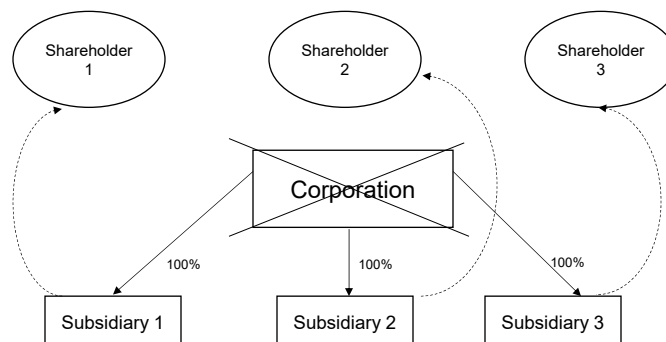
A split-off usually involves the distributing corporation making a non-pro-rata distribution of the stock of an existing or newly-formed subsidiary to some of distributing corporation's shareholders in exchange for their stock



53

SPLIT-UP

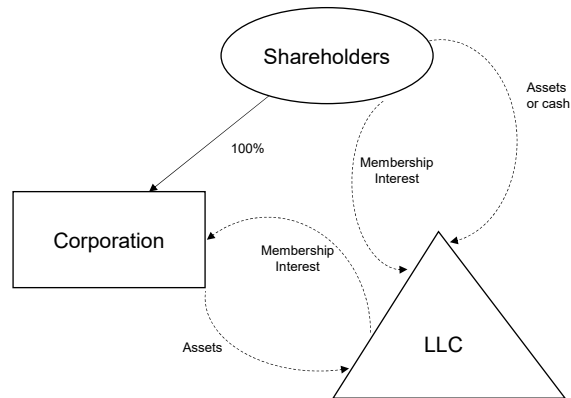
A split-up usually involves the distributing corporation making a non-pro-rata distribution of the stock of two or more existing or newly-formed subsidiaries to its shareholders in exchange for all of their stock in the distributing corporation



54

PARTNERSHIP DROP DOWN

Corporation can contribute appreciated assets into an LLC in exchange for membership interest with shareholders of corporation or other parties contributing cash or other assets



55

PARTNERSHIP DROP DOWN

- **Code Section 311(b) Issues**

- Risk that IRS may argue corporation's receipt of LLC interest did not constitute full and adequate consideration for the appreciated property it contributed and, therefore, "disappearing value" constitutes a distribution to the shareholders
 - [Cox Enterprises](#)
- If corporation makes a distribution of its LLC membership interest to its shareholders and takes valuation discounts to reduce gain under Code Section 311(b), IRS will likely attempt to deny
 - [Pope & Talbot](#)

56

PARTNERSHIP TERMINATIONS – GENERAL RULES

- **Partnership liquidations are called “terminations” in the Code.** Section 708(b) states that a partnership is considered terminated if no part of its business is carried on by any of its partners in a partnership.
- **Treatment to Distributee.** Section 731(a) applies. No gain shall be recognized to the partner unless amount distributed exceeds the partner's adjusted outside basis.
- A distribution from a partnership to a partner is not taxable to the partner except to the extent that:
 - Section 704(c)(1)(B) applies;
 - The amount of “money” distributed exceeds the partner's basis in the partnership; or
 - Section 737 applies; or
 - Section 751 hot assets rules apply, where distributions are not proportionate.

57

DISTRIBUTIONS – SECTION 704(C)(1)(B)

- Distribution of appreciated property (at the time of contribution to the partnership) to a non-contributing partner within seven years of contribution will trigger gain to contributing partner
- Counterpart to allocation of gain on sale of appreciated property to contributing partner.
- Example – Father contributes real estate to partnership worth \$100 with cost basis of \$60 and three children each contribute \$100 in cash
- If real estate is distributed out to a child two years later in redemption of his partnership interest, then father recognizes \$40 of taxable income
- If real estate is distributed to father in redemption of his partnership interest, then no gain recognized because of exception for distribution to contributing partner

58

DISTRIBUTIONS – SECTION 704(C)(1)(B)

- **Impact of Gifts of Partnership Interests**
 - For purposes of [Section 704\(c\)](#), donee steps into shoes of donor with respect to built-in gain
 - Example – Father contributes real estate to partnership worth \$100 with cost basis of \$60 and three children each contribute \$100 in cash, so father and each child owns a 25% partnership interest.
 - If father gifts a 5% interest to each child, then father will own a 10% partnership interest and each child will own a 30% interest
 - If real estate is sold for \$100, then gain of \$40 (\$100 less \$60 basis) is allocated as follows:
 - Father...\$16
 - Child #1...\$ 8
 - Child #2...\$ 8
 - Child #3...\$ 8

59

DISTRIBUTIONS – SECTION 737

- **General Rule:** triggered by contribution of appreciated property, followed by distribution of other property, other than cash or marketable securities, to contributing partner within seven years of contribution.
- **Gain is the lesser of Net Pre-Contribution Gain or Excess Distribution.**
 - Net Pre-Contribution Gain is amount of gain which distributee partner would recognize if all appreciated property contributed by distributee partner within seven years of contribution was distributed to another partner.
 - Excess Distribution is excess of the fair market value of the property distributed to the distributee partner over the basis in his partnership interest.

60

DISTRIBUTIONS – SECTION 737

- **Example – Father contributes real estate to partnership worth \$100 with cost basis of \$60 and three children each contribute \$100 of mineral royalties**
- **If \$100 of mineral royalties are distributed out the Father:**
 - Net Pre-Contribution Gain is \$40 (\$100 less \$60).
 - Excess Distribution is \$40 (\$100 less \$60).
 - If the value of the mineral royalties distributed to Father is \$130, then Excess Distribution is \$70 (\$130 less \$60).

61

DISTRIBUTIONS – SECTION 737

- **Previously Contributed Property Exception**
 - If any of the appreciated property was contributed by the distributee partner, then such property is excluded from the computation of Net Pre-Contribution Gain and Excess Distribution
- **Impact of Gifts of Partnership Interests**
 - For purposes of [Section 737](#), donee steps into shoes of donor with respect to Net Pre-Contribution Gain, unclear for previously contributed property exception

62

DISTRIBUTIONS – SECTION 751

- **Hot assets rules apply—only for non-proportionate distributions**
 - “Hot Asset” or Section 751 rules
 - Generally, distributions in a partnership termination does not result in any capital gain or loss
 - The exception under Section 751 looks to the underlying assets of the partnership being distributed.
 - This exception can swallow all capital gain in the transaction.

63

DISTRIBUTIONS – SECTION 751

- **Hot assets rules apply—only for non-proportionate distributions**
 - Decision path:
 - Determine whether hot asset rule applies.
 - Determine total gain/loss.
 - Determine gain/loss on deemed sale of hot assets.
 - Re-characterization: gain/loss on deemed sale of hot assets is re-characterized as ordinary
 - Does Hot Asset Rule apply?
 - Section 751 applies if a partnership has Section 751 assets.
 - What are Section 751 assets?
 - “unrealized receivables” (including depreciation recapture and similar adjustments) and inventory

64

DISTRIBUTIONS – BASIS

Basis of Property received in termination

- **Nonliquidating Distributions. Section 732(a)**
 - Basis of property received will be the lesser of:
 - the partnership's basis in the property distributed or
 - the partner's basis in the partnership in his or her partnership interest, adjusted for any money distributed or deemed distribution under [Section 752](#)
- **Liquidating Distributions. Section 732(b)**
 - Basis of property received is equal to partner's basis in partnership less any money received.

65

DISTRIBUTIONS – SECTION 731(C)

- **Section 731(c)**
 - Marketable securities treated as money
 - Results in gain recognition if FMV of marketable securities distributed exceeds basis of distributee partner's partnership interest
 - Gain reduced by partner's share of the partnership's net appreciation in the property distributed
 - Does not require any other partner to recognize gain

66

66

DISTRIBUTIONS – SECTION 731(C) EXCEPTIONS

- **Exceptions to § 731(c)**
 - Distributee partner previously contributed the marketable securities being distributed
 - Securities were non-marketable at time of acquisition (e.g. invest in company prior to it becoming publicly-traded)
 - Partnership is an “investment partnership”
 - Partnership has never engaged in a trade or business; and
 - Substantially all of the assets owned by the partnership are money and marketable securities and certain other assets
 - Pro rata distribution of appreciated marketable securities to the partners

67

DISTRIBUTIONS FROM PARTNERSHIP– SUMMARY

- **Ordering Rules**
 - [Section 704\(c\)\(1\)\(B\)](#)
 - [Section 731\(c\)](#)
 - [Section 737](#)
 - [Section 751](#)
- **Practice Points**
 - If partner contributes appreciated property to a partnership, the pre-contribution gain will be taxed to that partner when the gain is recognized by the partner.
 - A donee “steps into the shoes” of the donor with respect to allocation of pre-contribution gain, with possible exception of [Section 737](#).
 - If appreciated property is distributed to someone other than the contributing partner (within seven years of contribution), then contributing partner will recognize taxable income on amount of pre-contribution gain.
 - Exception for distribution of appreciated property back to contributing partner will be impacted by gifts of partnership interests.

68

QUESTIONS?

- Feel free to contact your presenters:
- [J. Robert Turnipseed](#)—(251)405-1311 or jrt@ajlaw.com
- [Robert M. Finkel](#)—(212)239-2000 or rfinkel@moritthock.com

