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EXCEPTION TO SECTION 731(C) FOR AN INVESTMENT PARTNERSHIP

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Normally, we all treat stock distributions as taxable in the year received. However, my firm recently met with a client in a situation where the taxation of the stock distribution was deferred to the next year. This is a technical example that is not seen every day, but it is an interesting example that CPAs may find handy.

Facts

The taxpayer received a 2012 Schedule K-1 from an LLC taxed as a partnership. This Schedule K-1 reported $1 on lines *6a ordinary dividends* and *6b qualified dividends*. *Line 19A distributions* indicated $1 in *cash distributions*. *Line 19C distributions* indicated $223,395 in *other property distributions.*

The partner footnotes included:

> "A distribution of the above number of shares of ABC company stock distributed to you in liquidation of your interest in XYZ, LLC. Please see the accompanying letter for additional information on determining your tax basis and holding period in the aforementioned shares."

The accompanying letter states:

> "It appears that the member owned only Class B Units in XYZ, LLC and as such, the member should have zero tax basis in these units as these units represent profits interests issued for services for which IRC Sec. 83(b) elections were made at issuance. As such, it would appear that the member should receive zero tax basis in the distributed shares of ABC.
>
> Under IRC Sec. 735, the member's holding period for the distributed shares of ABC is deemed to begin on Jan. 18, 2007, which is the same date that XYZ, LLC's holding period began. This date should be used as your acquisition date for the distributed shares of ABC for purposes of determining your holding period irrespective of the date(s) you were issued units in XYZ, LLC."

Research

Generally, under IRC section 731 (c), a marketable security like the described stock distribution on the taxpayer's Schedule K-1 is taxed in that year. A significant exception to section 731(c) is the exception for "investment partnerships." Section 731(c) does not apply to the distribution of marketable securities by an investment partnership to an "eligible partner." A partnership qualifies as an investment partnership if it has never engaged in a trade or business and substantially all of its assets have always consisted of certain specified assets, including money, stock, bonds, notes, plus some other very specific assets.

Conclusion

XYZ, LLC is deemed to be a qualifying investment partnership and has met the exception to IRC section 731(c). This allows the taxpayer receiving the distribution of shares to not pay taxes when received in 2012, but in the year when they are sold. The taxpayer was then able to wait until the share's fair market value increased in 2013 before selling the shares at a higher profit than if the shares were sold in 2012.

This sale qualifies for long-term capital gain treatment.