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Tax Issues in Transferring LLC and Partnership Interests

Navigating the Complex IRS Rules for Buying, Selling or Redeeming Partnership Interests

TUESDAY, NOVEMBER 6, 2018

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TAX ISSUES IN TRANSFERRING LLC AND PARTNERSHIP INTERESTS

November 6, 2018

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Terminology

- For brevity and because of the relative popularity of limited liability companies, these slides will often refer to LLCs, but such term should be understood to include general partnerships, limited partnerships, LLPs, LLLPs, and other entities that are taxed as partnerships for federal income tax purposes.
- Similarly, references to operating agreements also include partnership agreements, and references to members also include partners.

Overview

- Sale of Partnership Interest
  - General Rule
  - "Hot Asset" Rule
- Liquidating Distributions (Redemptions)
- Net Investment Income Tax – Application to Transfers of Partnership Interests

Sale of Partnership Interest

- Sale of Entire Interest
- Sale of Partial Interest
- Split Holding Period Issues

Sale of Partnership Interest

- A partner can dispose of his or her interest in many ways:
  - sale to third party
  - sale back to partnership
  - sale to other partner
- Economically, these transactions are identical, but the tax rules sometimes treat them differently.
- We first look at sales to third parties and/or other partners

Sale of Partnership Interest

- General Rule – IRC §741
- A sale of partnership interest is a sale of a capital asset.
- Holding period requirements for long/short term capital gain/loss are measured by the seller's ownership period, not by the partnership's holding period of the underlying assets.
- However, a significant exception to this general rule is the "hot asset" or IRC §751 rules.

Gain/Loss Calculation

Gain/Loss from the sale of a partnership interest:

amount received

\- adjusted tax basis

= gain (loss)

Gain/Loss Calculation

- Amount received in the sale of a partnership interest includes the following:
  - cash received
  - FMV of property received
  - liabilities of the seller that are assumed or relieved
    - formal liabilities
    - deemed liabilities for tax purposes (i.e., partner’s share of partnership liabilities)

Gain/Loss Calculation

- Adjusted Tax Basis Includes
  - the seller’s share of partnership liabilities
  - income/loss through the date of sale (as allocated)
  - in simple cases, will often line up with capital account balance plus share of partnership liabilities

Gain/Loss Calculation

Allocation of Partnership Liabilities

- Amount received and tax basis calculations both require consideration of partnership liabilities.
  - partnership recourse liabilities
  - partnership nonrecourse liabilities
- Also consider whether non-partnership liabilities are being assumed or relieved.

Gain/Loss Calculation

Example

- Adam is a member of Eden, LLC and sells his interest to Eve for $100 in cash.
- Adam's tax basis is $40, which includes $15 in partnership liabilities.
  - Amount received = $115
    - $100 cash
    - $15 partnership liabilities relieved
  - Adjusted tax basis = $40
  - Gain = $115 - $40 = $75

Sale of Partial Interest

- We have thus far assumed a sale of a partner's entire partnership interest.
- In some cases, however, a partner may sell only part of his or her interest.

Sale of Partial Interest

- Very little guidance.
- IRS position is that a taxpayer has a single tax basis, even if he/she owns different types of interests (i.e., owns a limited and general partnership interest; owns Class A and Class B units in an LLC).
- The tax regulations require that this tax basis must be "equitably apportioned" between what is sold and what is retained.
- *This differs from the sale of corporate stock which utilizes a tracing approach!*

Sale of Partial Interest

Example

- In 2013, Adam buys 10 units in Eden, LLC for $200.
- In 2015, Adam buys another 10 units for $1,000.
- In 2017, Adam sells 10 units (retaining the other 10) for $2,000.
- Assume that Adam has an overall tax basis of $1,200 (no liabilities, no income allocation in excess of distributions, etc.)

Sale of Partial Interest

Example

- If Adam allocates his basis ratably among the units, then the 10 units that are sold (representing 50% of the total units) will have a tax basis of $600 (i.e., 50% x $1,200 total tax basis).
- amount received = $2,000
- tax basis = $600
- gain = $1,400

Sale of Partial Interest

- The ratable/FMV allocation approach is supported by the regulations and by commentators.
- An alternative is a tracing approach.
- Assume that Adam's tax basis in each block of LLC units is equal to his original purchase price.
- If Adam sold the second block, he might argue that he recognizes only $1,000 of gain (i.e., $2,000 amount received less $1,000 tax basis).

Sale of Partial Interest

- What if a seller owns different *<u>types</u>* of LLC or partnership interests?
- Limited vs. General Partnership Interests
- Senior vs. Junior Interests
- Class A vs. Class B
- The majority view is to allocate total basis in proportion to the FMV of the interests.

Sale of Partial Interest

- Example: Eve owns both LP and GP units in a partnership. She has total basis of $100, and is selling her LP interest for $60. Assume the FMV of the GP interest is $90.
- Total FMV = $150, so LP interest represents 40% of the total.
- Accordingly, $40 of basis (40% x $100) is allocated to the LP interest
- Gain = $20 ($60 amount received less $40 basis)

Split Holding Period

- Because there is a significant capital gains rate differential, it can be important to determine whether the long-term capital gains holding period has been satisfied.
- If the seller acquired her partnership interest at different times, split holding periods may come into play.
- The holding period of a partnership interest is determined by reference to the holder, not the holding period of the underlying partnership assets.

Split Holding Period

<u>Example</u>: On 1/1/2017, Smith contributed cash and real property to ABC, LLC. The cash is $1,000. The real property is worth $2,000, has a basis of $100, is a capital asset and was acquired by Smith on 1/1/2000.

- The ratio of the cash to the real property is 33% to 67%.
- Smith has split holding periods.
  - 33% of her LLC interest has a holding period that started on 1/1/2013 (the cash contribution).
  - 67% of her LLC interest has a holding period that started on 1/1/2000 (the real property contribution).

Split Holding Period

- On 7/1/2017, Smith sells her LLC interest for $2,000. At the time, her basis is $1,100, resulting in gain of $900. (Assume no re-characterization of the gain under §751.)
- Because Smith has a split holding period for her LLC interest, the gain is allocated ratably:
  - 33% of her gain ($300) is treated as a short-term capital gain because the holding period began on 1/1/2017.
  - 67% of her gain ($600) is treated as long-term capital gain because the holding period began on 1/1/2000.

"Hot Asset" Rule

- Under the general rule, a sale of a partnership interest gives rise to capital gain or loss
- However, there is a significant exception to this rule that looks to the underlying assets of the partnership.
- This exception can dwarf the general rule depending on the business of the partnership.

Digression

- The main adverse consequence of the hot asset rule (IRC §751) is that income that would otherwise be characterized as capital gain is re-characterized as ordinary income.
- Note that under IRC §199A, certain types of ordinary income are effectively taxed at a special lower rates.
- For example, certain types of ordinary partnership income that is allocated to an individual and that would otherwise be subject to tax at rates as high as 37% may be eligible for an effective tax rate of about 30%.

Digression

- The proposed regulations issued under IRC §199A make clear that gain re-characterized as ordinary income under §751(a) or (b) can qualify for this preferential treatment.
- See Prop. Treas. Reg. §1.199A-3(b)(1)(i).
- Note – there are many requirements and conditions that must be met in order to qualify for the benefits of §199A.

“Hot Asset” Rule

- Decision path:
  1. Determine whether hot asset rule applies.
  2. Determine total gain/loss.
  3. Determine gain/loss on deemed sale of hot assets.
- End result – any gain/loss on deemed sale of hot assets is re-characterized as ordinary

"Hot Asset" Rule

- Does Hot Asset Rule apply?
    - §751 applies if a partnership has §751 assets.
- What are §751 assets?
    - "unrealized receivables" and inventory

§751 Assets

- "Unrealized Receivables"
  - generally – receivables for goods delivered (or to be delivered) or for services rendered (or to be rendered)
  - BUT ONLY to the extent not previously included in income under the partnership's method of accounting
  - also: recapture property to the extent of ordinary income recapture amount

§751 Assets

- Inventory
  - property held for sale to customers in the ordinary course of business (including real estate held by a dealer whether or not included in inventory)
  - any other property that, on the sale or exchange by the partnership, would be considered property other than a capital asset or §1231 property; and
  - any other property that, if held by the transferor partner, would be described above

Total Gain/Loss

- Compute gain/loss as if §751 did not apply
  - Accordingly, the general rule applies, with caveats for partial interests, etc.

§751 Deemed Sale

- Determine gain/loss on all §751 assets – need FMV and tax basis of all §751 assets.
- Regulations set out specific rules:
  - receivables generally valued at present value of net cash expected, reduced by estimated cost of delivery or performance – not face value
  - inventory items valued at market using §471 principles
- Where book/tax basis differences exist, tax basis computations can be complicated.

Re-Characterization

total gain/loss

\- §751 deemed sale gain/loss

= capital gain/loss

Example

- Jones sells his 25% interest in ABC, LLC for $1,000
- Total outside basis = $750
- Two assets:
  - real estate held for investment – capital asset
    - FMV = $500
    - tax basis = $750
  - inventory items – §751 asset
    - FMV = $500
    - tax basis = $0

Example

- Does §751 apply?
  - Yes because ABC, LLC has §751 assets.
- Total gain/loss?
  - amount received = $1,000
  - tax basis = $750
  - gain = $250

Example

- Gain/loss on §751 deemed sale?
  - Amount received = FMV = $500
  - Tax basis = $0
  - Gain = $500

Example

- Re-characterization
  - Total gain/loss = $250
  - §751 gain/loss = $500
  - Capital gain/loss = - $250
- In this case, the inherent loss in the capital asset and the large gain in the hot assets are preserved under §751.

Liquidating Distributions

- General Rules
- §736 Issues

Liquidating Distributions

- In general, a liquidating distribution can be analogized to a stock redemption.
- The partner receives a distribution from the partnership in exchange for or liquidation of his or her interest in the partnership.
- Can be a single or series of distributions.

Liquidating Distributions

- The tax treatment of a liquidating distribution varies depending on what type of property is distributed.
  - cash – gain/loss recognized
  - “marketable securities” – treated same as cash
  - all other property – generally no gain/loss – instead take the property with a carryover basis.

Liquidating Distributions

- Cash includes “deemed” cash distributions from relief of liabilities.
- “Marketable securities” are financial instruments and foreign currencies that are actively traded – these are treated as cash substitutes and the same tax consequences attend them.
    - “financial instruments” defined as stocks and other equity interests, debt, options, forward or futures contracts, notional principal contracts, and derivatives

Liquidating Distributions

- If cash or marketable securities are received, and the total exceeds the partner's outside tax basis, then the difference is recognized as gain.
- Loss can be recognized but only if the to the extent the distribution consists solely of cash or §751 assets.
- Receipt of other property generally will not result in gain or loss. Instead, the partner's outside tax basis will be spread over the received property.

Retirement Payments

- An exception to the general rules on liquidating distributions applies in highly specific circumstances.
- §736 governs payments to retiring partners. Payments are separated into two classes:
  - payments for the partner's interest in partnership property ("§736(b) payments"), and
  - all other payments ("§736(a) payments").

Retirement Payments

- In general, §736(b) payments are taxed as distributions. So, the general rules on liquidating distributions apply to such payments.
- §736(a) payments are treated as distributive share payments or guarantee payments depending on whether they are a function of partnership income.
- KEY – a §736(a) payment is effectively excluded from partnership income and taxed only to the retiring partner.

Retirement Payments

Example

- Red, a member of Flag, LLC, receives a payment of $100 to induce Red to retire. At the time, the FMV of Red's interest in Flag, LLC is $25.

- Under these facts, only $25 is treated as a payment for Red's interest in Flag property. That amount is a §736(b) payment and is taxed under the liquidating distribution rules (i.e., gain to the extent the cash exceed his tax basis in his LLC interest).

Retirement Payments

Example

- The balance of the payment – $75 – is treated as a §736(a) payment.
- Because it is a fixed payment, it is treated as a guaranteed payment and is excluded from the income of the company and taxed only to Red.

Retirement Payments

Service Partnerships

- A special rule applies to a payment by a service partnership to a general partner.
- A service partnership is one in which capital is not a material income-producing factor.
- In general, §736(a) payments also include payments for:
  - partner’s share of unrealized receivables
  - partner’s share of unstated goodwill

Retirement Payments

Service Partnerships

- This expands §736(a) treatment to include some payments that are for the partner's interest in certain types of partnership property.
- Effectively, a partnership can convert part of a liquidating distribution into an income exclusion.

Tax on Net Investment Income

- Variously referred to as the “unearned income Medicare contribution tax” or the “net investment income tax” (“NIIT”) or the “Obamacare tax”.
- Applies to individuals, estates and trusts.
- Effective 1/1/2013 -- enacted as part of the 2010 Health Care Act.

Tax on Net Investment Income

- The tax is equal to 3.8% of the tax base.
- Tax base is the lesser of:
  - The net investment income of the taxpayer or
  - The excess of the modified AGI of the taxpayer over the threshold amount.

Tax on Net Investment Income

- Modified AGI for these purposes is identical to AGI for most taxpayers.
- For taxpayers who utilize the foreign earned income exclusion under Code Section 911, there are additional adjustments that are made.

Tax on Net Investment Income

- The "threshold amount" is:
  - $250,000 for joint returns and surviving spouses
  - $125,000 for separate return filers
  - $200,000 in all other cases

Tax on Net Investment Income

- The NIIT and the additional 0.9% medicare tax may apply to the same taxpayer in the same tax year, but not to the same items of income:
  - NIIT only applies only to net investment income
  - The 0.9% additional medicare tax applies only to wage and self-employment income
- Estimated tax rules apply.

Net Investment Income - General

Why is this relevant to this webinar?

- "net investment income" (NII) generally refers to passive types of income, and also includes the net taxable gain attributable to the disposition of property held in a covered NIIT trade or business

- IMPORTANT – to prevent avoidance, the NIIT rules also apply to sales of interests in a NIIT trade or business.

NIIT – Deemed Asset Sale

- NIIT attempts to treat the sale of a partnership interest the same as the sale of a partnership's assets.
- Proposed regulations: Prop. Reg. §1.1411-7
- Methodology:
  - Treat partnership as selling all its assets immediately prior to the sale of the partnership interest.
  - Determine the gain or loss from the deemed sale that would be allocated to the selling partner.
  - Net gain from deemed sale of assets of NIIT trade or business are included in the definition of net investment income and subject to 3.8% tax (even if would otherwise be CG under regular income tax rules).
- Proposed regulations contain numerous caveats, details.

Net Investment Income – Trade/Business

- NIIT will apply to a trade or business that is:
  - a passive activity with respect to the taxpayer, within the meaning of Code Section 469
  - a trade or business of trading in financial instruments or commodities, as defined in Code Section 475(e)(2).
- Recently regulations provide guidance on the application of NIIT to these businesses, including definitions for the terms “financial instruments” and “commodities.”
- Under the proposed regulations, NIIT does not apply to any other trade or business.

Net Investment Income - Timing

- Because income tax principles apply to NIIT, gain that is deferred for income tax purposes is also deferred for NIIT purposes.

- Conversely, disallowance provisions applicable in determining adjusted gross income (AGI) (e.g., the limitations on investment income or the passive activity loss limitations) also apply to the computation of NII.

Thanks!

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Selected Tax Issues in Transferring LLC and Partnership Interests

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Partnership Mergers: What is a "Merger"?

- Definition of partnership "merger" is fuzzy.
- However it is clear that:
  - Partnership "merger" does not include *many* transactions that *are* undertaken under state merger statutes.
  - Partnership "merger" does include *many* transactions that are *not* undertaken under state merger statutes.
- Any time partnership transaction(s), with or without state law merger, result in fewer partnerships at the end than at the beginning, consider:
  - Has there been a partnership "merger" for tax purposes?

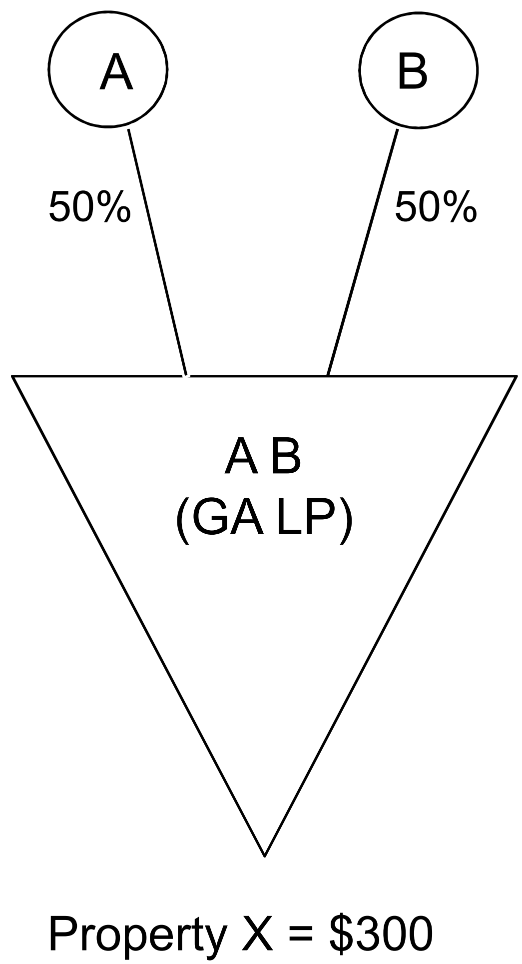
Termination of Partnership

- Under the current Internal Revenue Code, a partnership is considered terminated “only if no part of any business, financial operation, or venture of the partnership continues to be carried on by of of its partners in a partnership.” Code § 708(b)(1).
  - If only one partner is left after a transfer, the partnership has terminated even if the legal entity remains intact.
- Before 2018, a partnership was also considered terminated if “within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in the partnership capital and profits.” Former Code § 708(b)(1)(B) (prior to the 2017 Tax Cuts and Jobs Act).
  - This was sometimes called a “technical termination.”

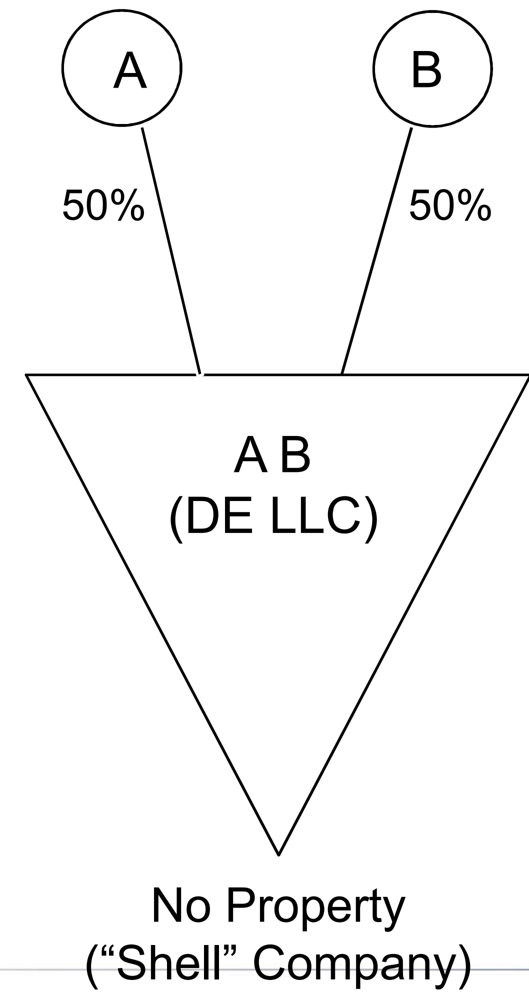
Example: State Law Merger Without Tax Merger

- Many partnership mergers under state law are intended merely to change the state law form of entity and/or the state of formation.
  - For example, changing a Georgia LP to a Delaware LLC might be accomplished by merging the LP into a new LLC.
  - State law mergers of this kind are becoming less common now that many states authorize direct conversions without mergers.
- In transactions like this, the IRS says that there is no partnership merger and no partnership termination.
- State law form of transaction is irrelevant to the IRS. See Rev. Rul. 95-37, 1995-1 CB 130.

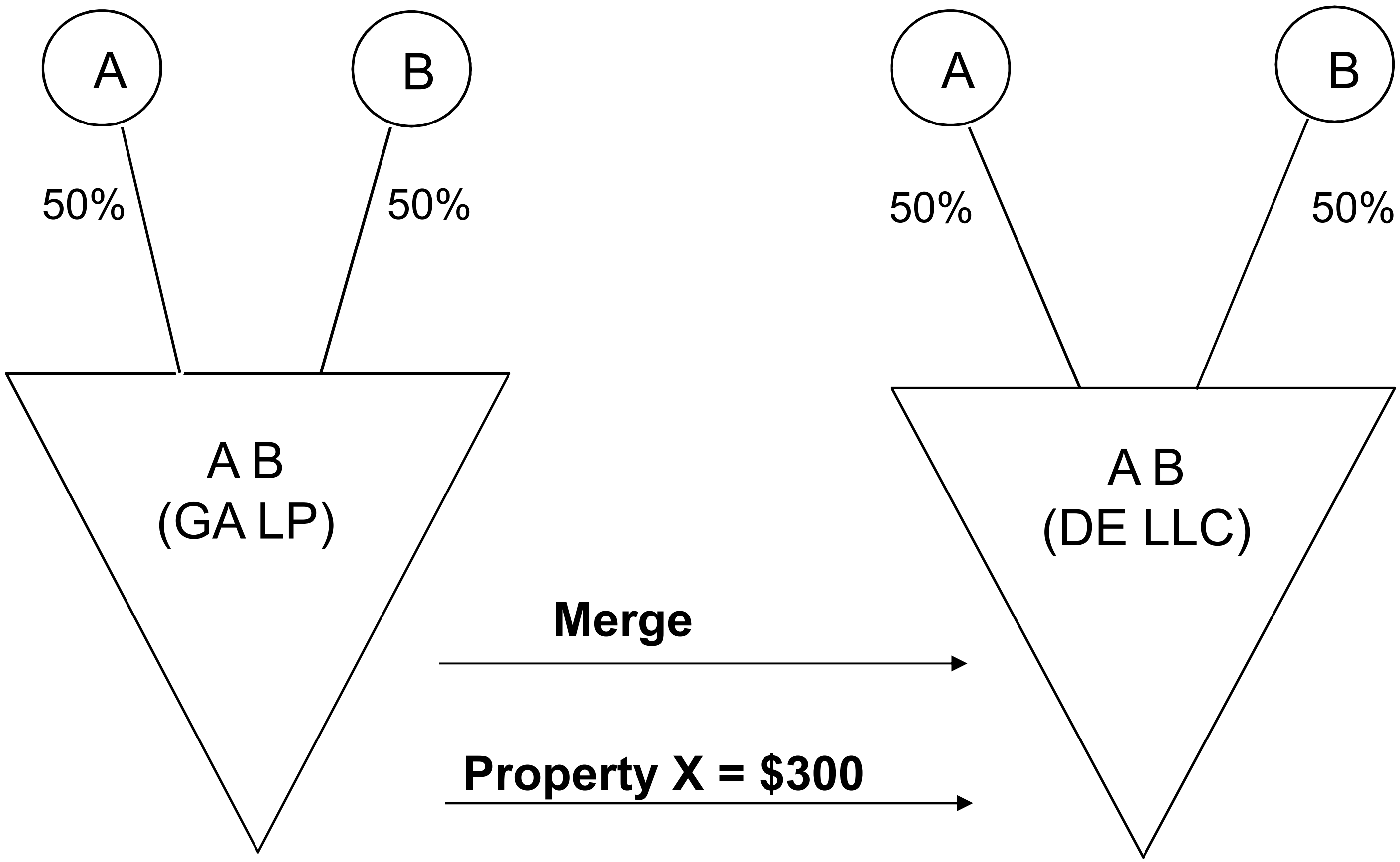
"Non-Merger" Example: Initial Situation



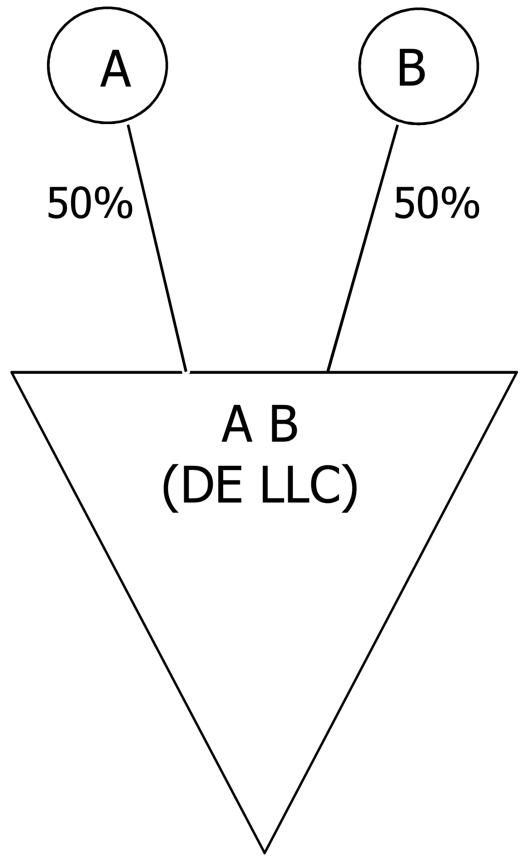
"Non-Merger" Example: Shell Partnership is Formed



"Non-Merger" Example: State Law Merger



"Non-Merger" Example: End Result



Property X = $300

AB (GA LP) = AB (DE LLC)

- AB (GA LP) is the same partnership for tax purposes as AB (DE LLC).
- There is no termination of AB.
  - Tax year does not close.
  - EIN does not change.
  - There is no partnership distribution or contribution.
  - No property is deemed transferred.
- However, the transaction may have tax consequences.
  - Most importantly, the amount of liabilities allocated to a member may go down, which is treated as a distribution to the member.

Merger vs. Conversion

- Tax treatment of the ***merger*** of AB (GA LP) into AB (DE LCC) is more analogous to the state law treatment of a ***conversion*** of AB (GA LP) into AB (DE LLC).
- From a tax viewpoint, there should be no difference between a state law merger into a shell and a state law conversion.

Equivalent Transactions

- To the IRS, ***all of the following actual transactions are identical***:
  - Merger of AB (GA LP) into AB (DE LLC).
  - Conversion of AB (GA LP) to AB (DE LLC).
  - Contribution of all interests in AB (GA LP) to AB (DE LLC).
  - Contribution of all assets of AB (GA LP) to AB (DE LLC).
  - Distribution to A and B of all assets of AB (GA LP) and immediate recontribution to AB (DE LLC).

Mergers For Tax Purposes

- As noted, the merger of AB (GA LP) into AB (DE LCC) was not treated as a merger for tax purposes. For tax purposes:
  - No partnership terminated.
  - No assets moved.
- In a transaction treated as a partnership merger for tax purposes:
  - At least one partnership does terminate.
  - Assets are deemed to move.

Partnership Mergers = Distributions + Contributions

- A merger that is governed by the tax rules on partnership mergers is characterized as a combination of:
  - Distributions.
  - Contributions.
- Distributions and contributions are often tax-free in the partnership environment.
- Since the basic partnership rules on distributions and contributions are much more favorable than those for corporations, there is no need for the elaborate definitions of tax-free mergers found in the corporate tax context.
- Although there are some very important exceptions, the ***general*** rule of Code § 731 renders most distributions tax-free to both the partner and the partnership.

Partnership Mergers: Distribution Aspect

- But always watch out for the exceptions:
  - Distribution of cash/marketable securities in excess of basis (including "deemed distribution" on liability shift). Code §§ 731(a)(1), 752(b).
  - Change in shares of ordinary income ("hot") assets. Code § 751(b).
  - "Disguised sale." Code § 707(a)(2)(B).
  - "Mixing bowl." Code §§ 704(c)(1)(B) and 737.

Partnership Mergers: Distribution Aspect

- The general rule of tax-free distributions by partnerships is in stark contrast to the comparable Subchapter C provisions, which in most instances impose tax on both:
  - **The shareholder**.
    - Code §§ 301 and 331.
  - **The corporation**.
    - Code §§ 311 and 336.

Partnership Mergers: Contribution Aspect

- Code § 721 generally grants tax-free treatment to both the partner and the partnership on a contribution of property in exchange for an interest in a partnership.
- Code § 721 is partially matched by corporate nonrecognition provisions, especially:
  - Code § 351 (nonrecognition to contributing shareholder).
  - Code § 1032 (nonrecognition to corporation).
- Code § 351 is less generous, however, in that the contributing shareholders are required to have 80 percent control of the corporation immediately after the exchange.
  - No comparable requirement is imposed on contributions in exchange for partnership interests.

Partnership Mergers: Which Partnership Survives?

- Code § 708(b)(2)(A) is the sole Code provision on partnership mergers.
- All this Code provision does is define the survivor of a partnership merger.
- It says nothing about the other consequences of partnership mergers, or even about what a partnership "merger" means. The Code provision existed long before there were partnership mergers under state law.

Partnership Mergers: Which Partnership Survives?

- "In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of [Code § 708], be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.“ Code § 708(b)(2)(A). See Treas. Reg. § 1.708-1(c).

Partnership Mergers: Which Partnership Survives?

- What if the members of ***two*** (or more) partnerships own more than 50% of the resulting partnership?
  - The continuing partnership is the one that is credited with the largest net value of assets. Treas. Reg. 1.708-1(c)(1).
- What if the members of ***no*** partnerships own more than 50% of resulting partnership?
  - All the merged partnerships terminate. Treas. Reg. 1.708-1(c)(1).

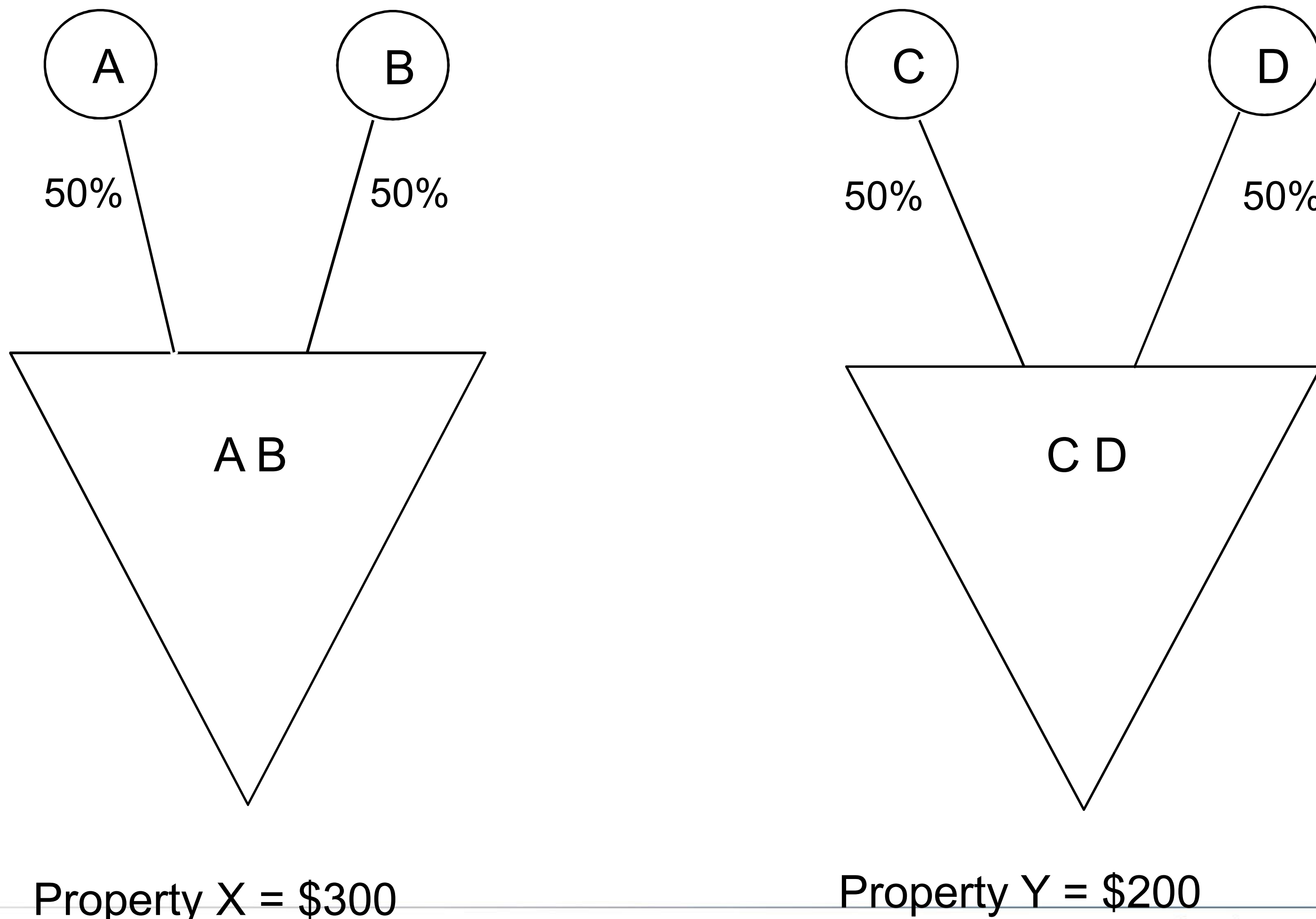
Partnership Mergers: Assets Over (Default Form)

- In most instances, partnership mergers will be deemed to take the "assets-over" form.
- The actual form of transaction under state law is irrelevant (except for "assets up," as noted below).
- It does not matter whether there is a merger under state law.
- Under the "assets over" form, the partnership that is considered terminated is deemed to do the following:
  – Contribute all of its assets and liabilities to the resulting partnership in exchange for an interest in the surviving partnership.
  – Immediately afterwards distribute interests in the resulting partnership to its partners in liquidation.

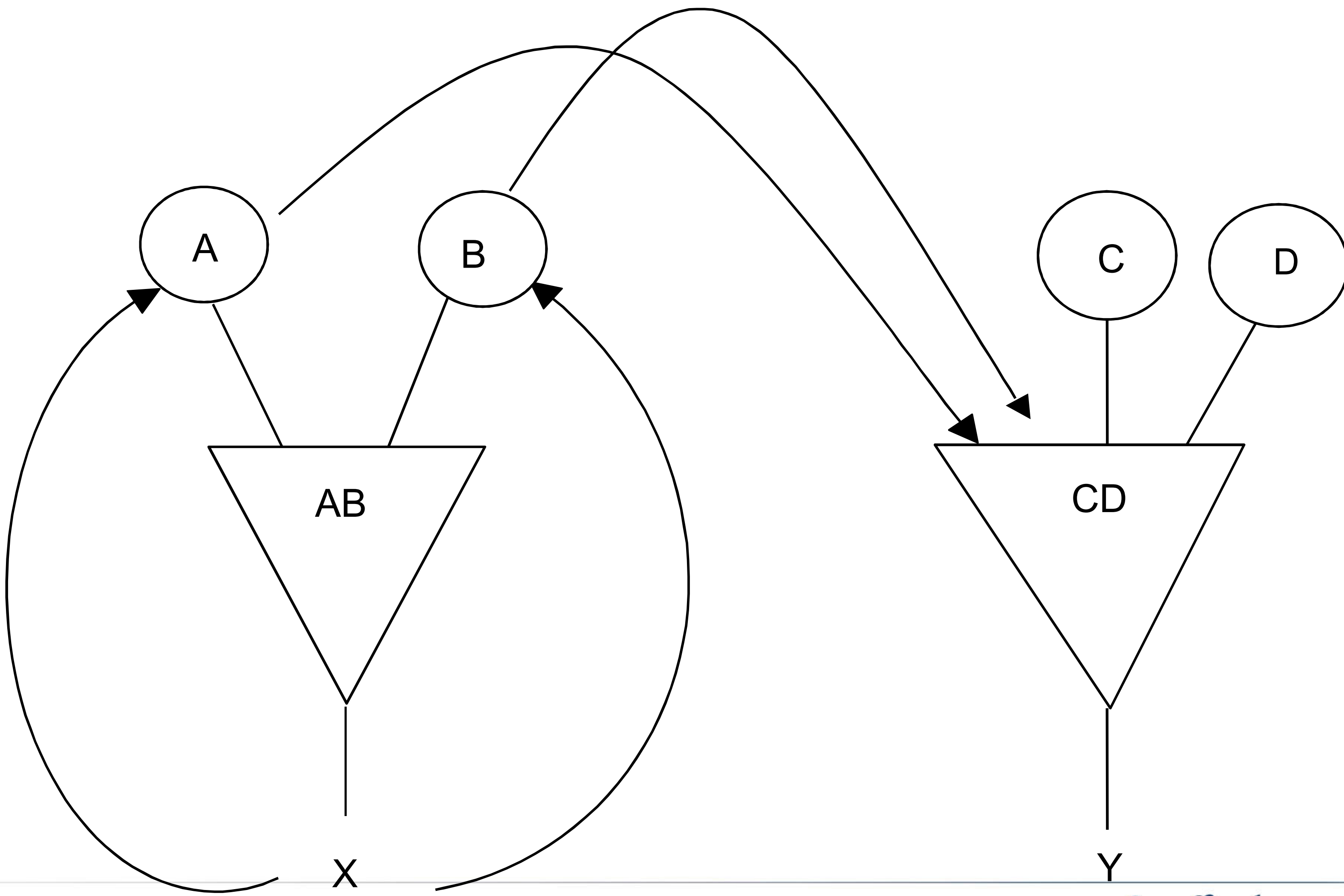
Partnership Mergers: Assets Up

- However, if a partnership merger ***actually takes*** the form of an "assets up" transaction, that form will be respected.
- Under this form:
  - The partnership that is terminated distributes all of its assets to its partners in liquidation.
  - Immediately afterwards the partners contribute those distributed assets to the resulting partnership.
- An "assets up" transaction is never a merger under state law.
- However, it is still governed by the tax rules on partnership mergers.
- "Assets up" merger may be beneficial, for example, where outside basis (partners' basis in their partnership interests) exceeds inside basis (partnership's basis in its assets).
- Most of the time "assets over" is okay.

Partnership Merger Example



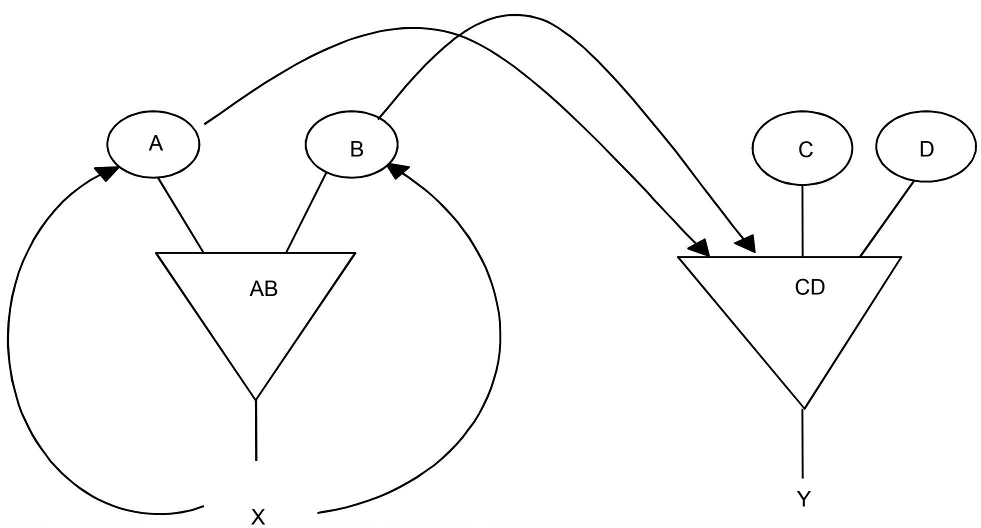
Partnership Merger Example: What the Parties *Think* Happens



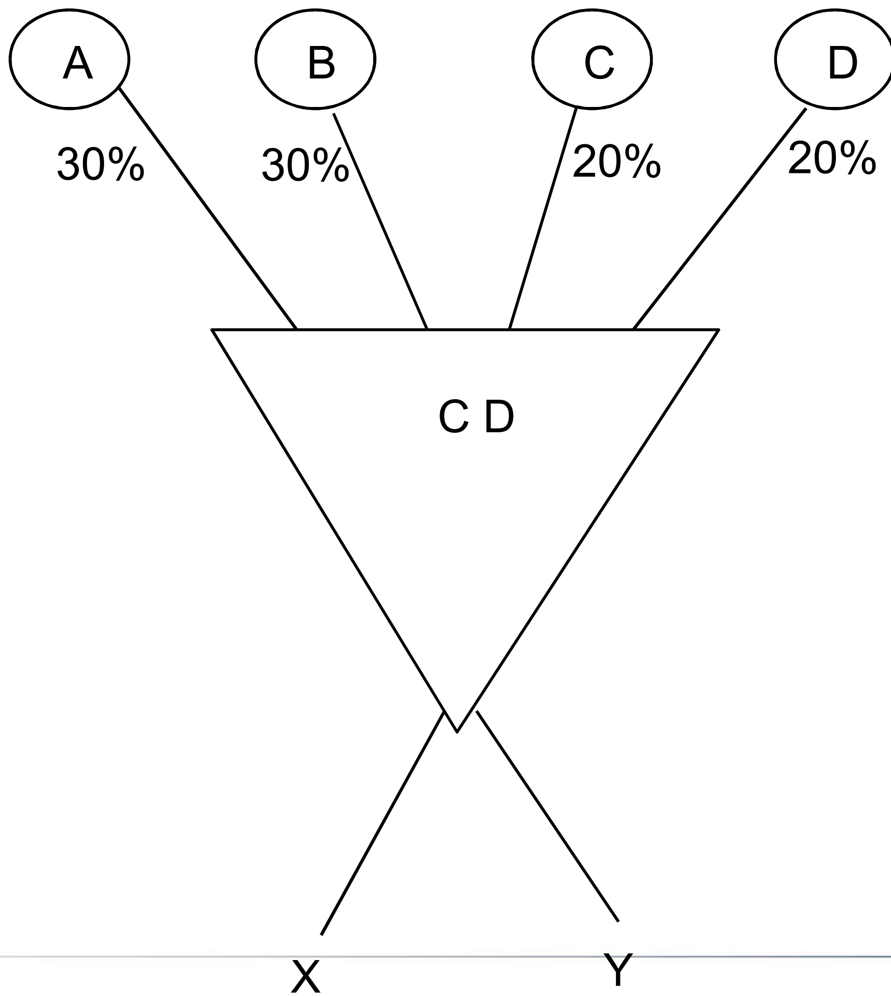
Partnership Merger Example: What the Parties *Think* Happens

Parties think that:

1. X is distributed to A and B in liquidation of AB.
2. A and B contribute X to CD in exchange for interests in CD.



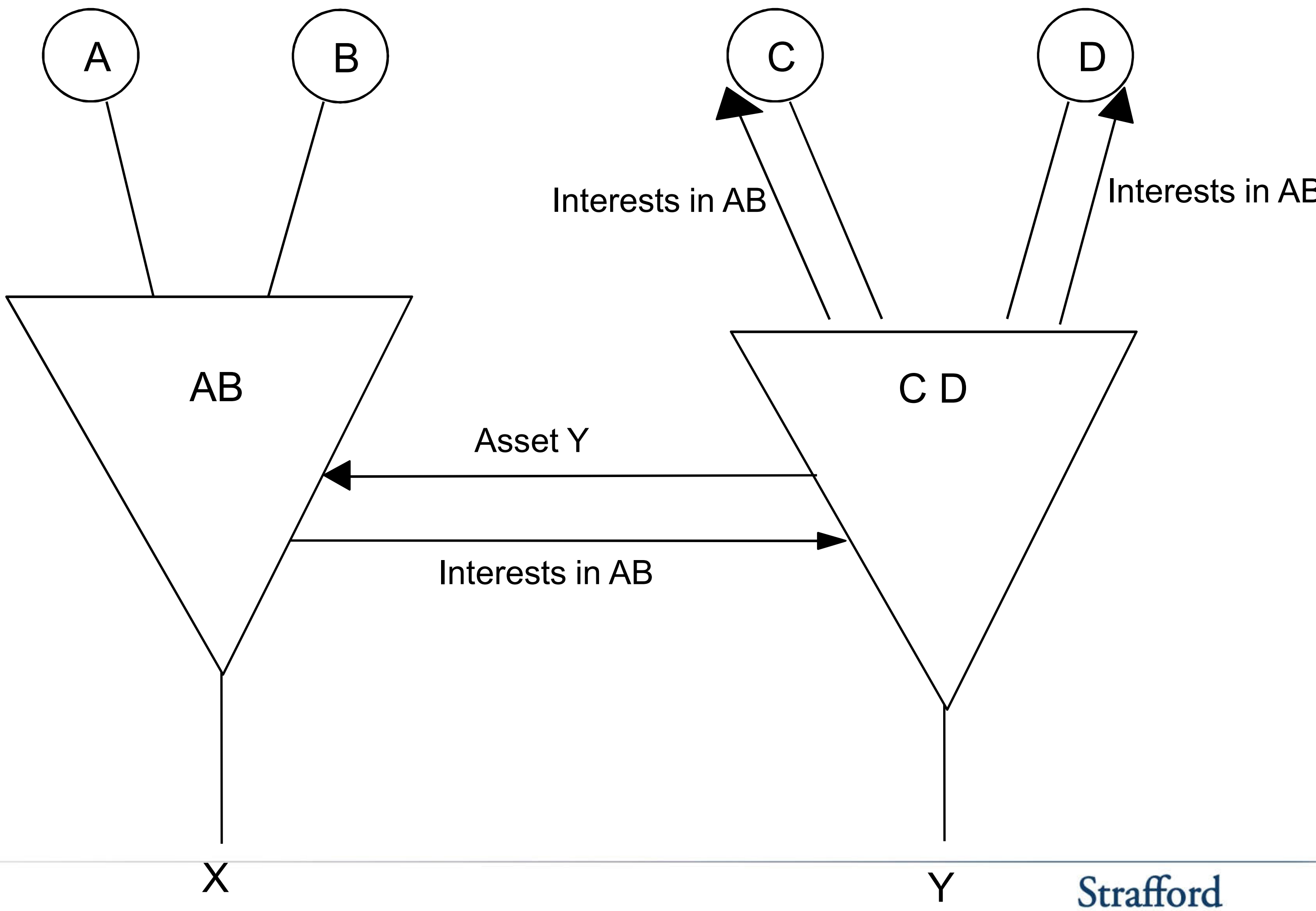
Partnership Merger Example: What the Parties *Think* Happens



Partnership Merger Example: Two Perspectives

- The parties think this was an "assets up" transaction, in which the assets of AB were indirectly transferred to CD.
- However, the IRS thinks this was an "assets over" transaction, in which the assets of CD were transferred to AB.

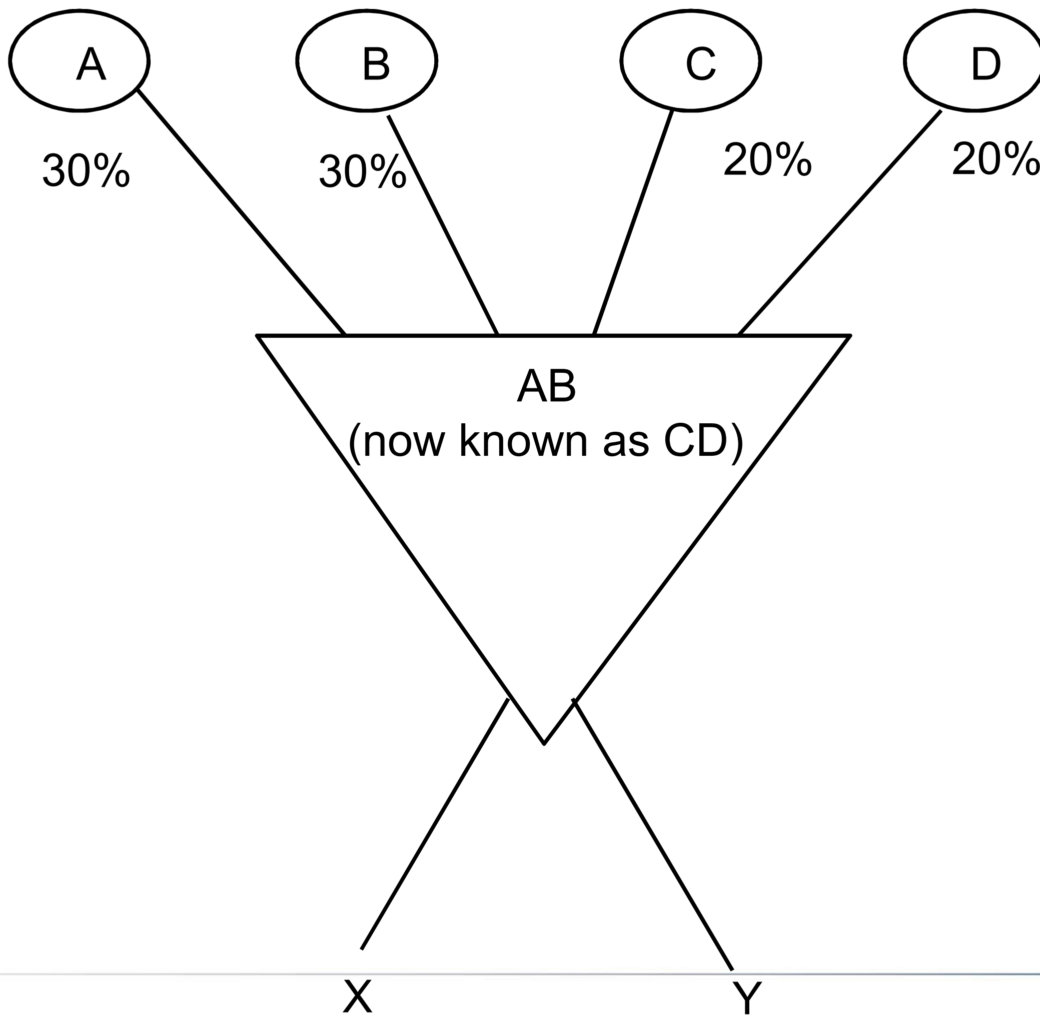
Partnership Merger Example: What the IRS Thinks Happens



Partnership Merger Example: What the IRS Thinks Happens

- IRS thinks that C and D joined AB, instead of A and B joining CD.
- IRS thinks that AB just happened to change its name to CD.
- The state law LLC or partnership that, according to the tax rules, changed its name to CD, will use the employer identification number formerly used by AB.
- AB has disappeared under state law but continues under the tax rules.

Partnership Merger Example: What the IRS Thinks Happens



Seven Equivalent Transactions: To the IRS, These Are All Identical

- Merger: AB into CD.
- Merger: CD into AB.
- Asset transfer: CD to AB.
- Asset transfer: AB to CD.
- Contribution of interests in CD to AB.
- Contribution of interests in AB to CD.
- Distribution of assets to A and B with immediate recontribution to CD.

The Only Alternative

- Each of the foregoing transactions is treated as an "assets over" merger, with AB surviving.
- The only alternative the IRS would recognize as different is an actual "assets up" transaction, with AB surviving, that is:
  - Distribution of assets to C and D.
  - Immediate recontribution to AB.

A Limited Exception

- If certain requirements are met, the regulations permit the partners of the merging partnership in an "assets over" transaction to be treated as selling their ***interests*** to the surviving partnership. Treas. Reg. § 1.708-1(c)(4).
- This special rule helps avoid taxable gain to the continuing partners of the merging partnership, who are not selling.

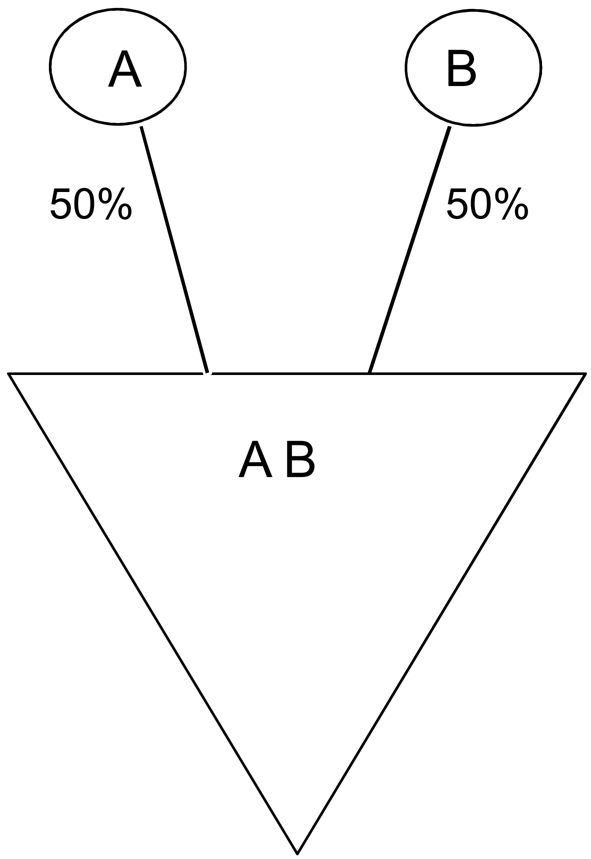
Disguised Sales

- Disguised Sales of Assets to or From a Partnership:
  - Final Regulations were issued in 1992. Treas. Reg. § 1.707-3 through -9.
  - General rule: Transfer to a partnership is treated as a sale, rather than as a tax-free contribution, if:
    - The transfer of money or other consideration would not have been made but for the transfer of property; and
    - In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.
      - Treas. Reg. § 1.707-3(b)(1)

Disguised Sales

- <u>Disguised Sales of Partnership Interests</u>:
  - The law is extremely underdeveloped.
  - Proposed regulations on disguised sales of partnership interests were published in 2004. REG-149519-03, 69 Fed Reg. 68838 (Nov. 26, 2004).
  - The proposals were universally panned, and the IRS took the unusual step of formally withdrawing them.
  - Taxpayers were advised instead to look to statutory language, case law and legislative history. Ann 2009-4, 2009-8 IRB 597.
    - Statute (enacted 1984) gives almost no guidance.
    - Case law accords great flexibility to the parties.
    - Legislative history indicates that Congress disapproved of some of the case law, but Congress left it almost entirely up to regulations to fill in the details – regulations that have never been issued and probably never will be.

Disguised Sale of Partnership Interest: What is at Stake?

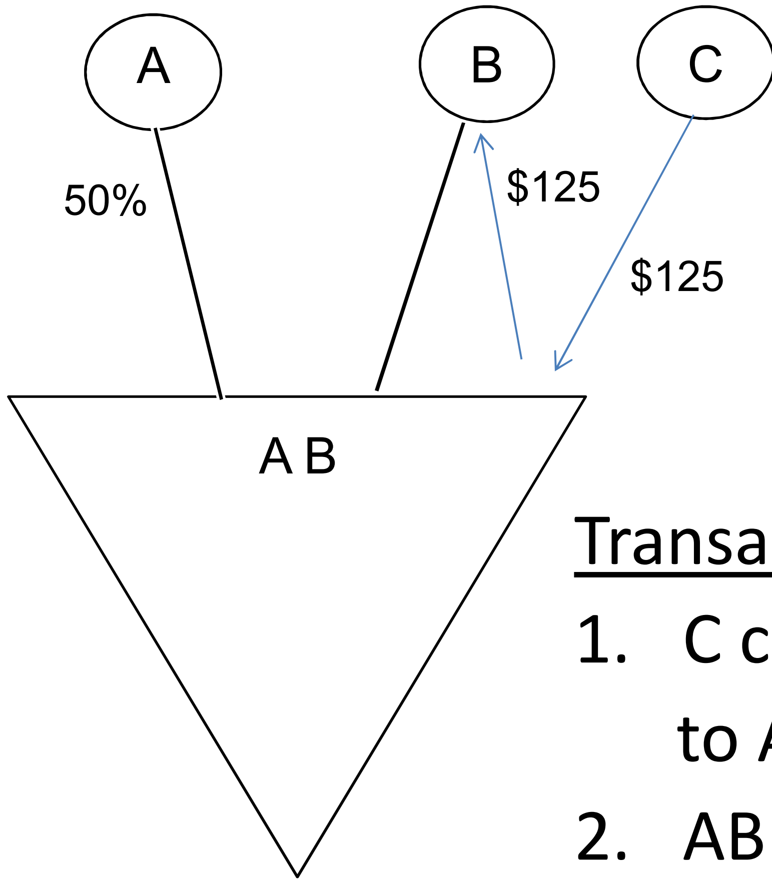


B's Interest:

FMV = 250

Basis = 100

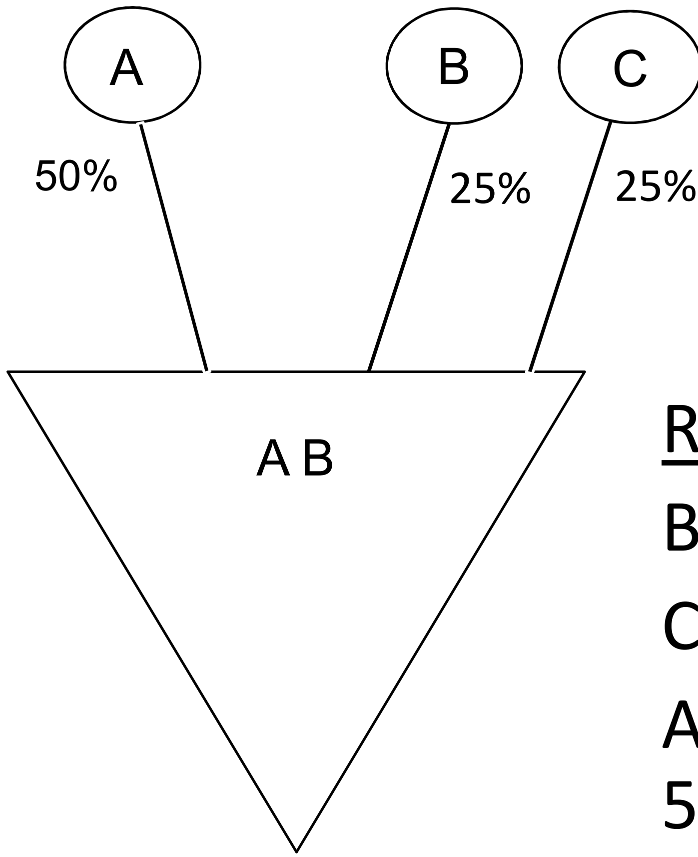
Disguised Sale of Partnership Interest: What is at Stake?



Transaction:

1. C contributes $125 to AB.
2. AB distributes $125 to B.

Disguised Sale of Partnership Interest: What is at Stake?



Result:

B owns 25% interest.

C owns 25% interest.

A continues to own 50% interest.

Alternative Analyses of Same Transaction

- <u>If the form is respected:</u>
  - Treated as $125 contribution by C followed by $125 distribution to B.
  - B recovers all $100 of basis (Code § 731).
  - B has $25 gain.
- <u>If the form is not respected:</u>
  - Treated as C purchasing half of B's interest.
  - B recovers $50 (half) of basis.
    - Basis recovery is less favorable on a sale of part of an interest than on a non-liquidating distribution.
  - B has $75 gain.

What Is the Correct Analysis?

- The available authority suggests that the form is ***generally*** respected.
- In the absence of regulations, taxpayers ***generally*** do not worry about disguised sales of partnership interests except in the most blatant situations.
- Potentially relevant factors:
  - Are the contribution and distribution simultaneous?
  - Would C have contributed the $125 but for the $125 distribution to B?
  - Would the partnership have distributed the $125 to B but for the $125 contribution by C?
  - Were the contribution and distribution directly related?
  - Was there much time between the contribution and distribution?
  - Can the distribution to B be traced to the contribution by C?

Transfer of Debt for Equity

- When a creditor discharges debt, the debtor has cancellation of indebtedness (COD) income.
- What if the creditor of a partnership gives up the debt owed by the partnership and takes equity in the partnership in exchange?
- Before 2004, some taxpayers took the position that the creditor's contribution of debt to the partnership was tax-free, and that the partnership had no COD income, regardless of the value of the partnership interest.
- Congress then amended Code 108(e)(8) to remove all doubt.
- The partnership is now treated as satisfying the debt with an amount of money equal to the fair market value of the partnership interest.

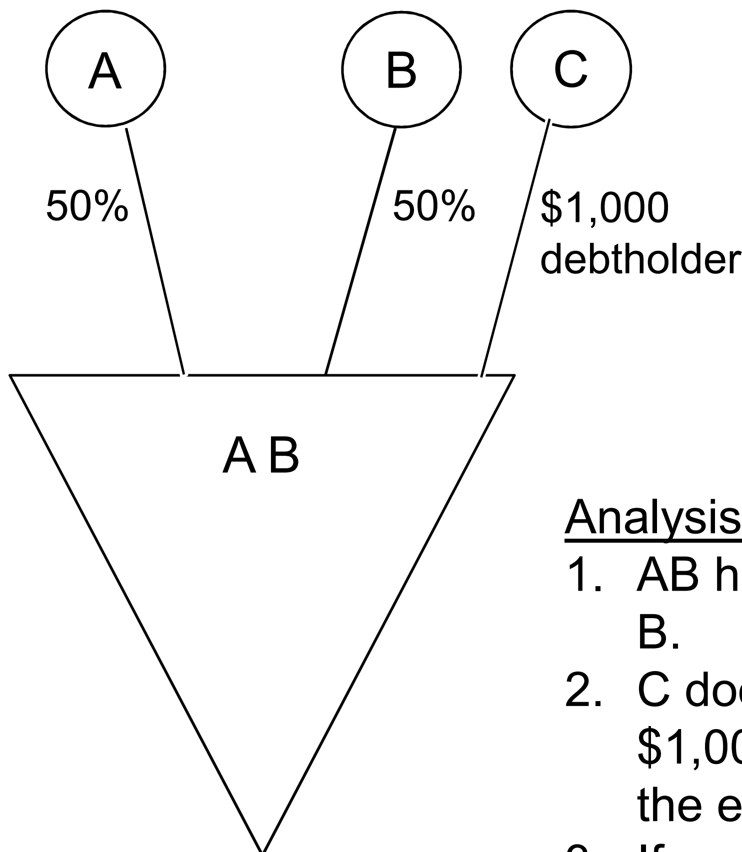
Section 108 Regulations

- Final regulations on the contribution of debt by the creditor in exchange for a partnership interest were issued in 2011. Reg § 1.108-8.
  - The partnership has COD income if the fair market value of the partnership interest is less than the debt.
  - The COD income usually is allocated to the partners that had included the debt in basis before the transaction.
- However, the lender does not have a bad debt deduction; just a higher basis in the partnership interest.
  - Loss on the partnership interest, if and when recognized, is likely to be capital loss, rather than an ordinary business bad debt deduction.
  - The lender does not get any step-up in its share of partnership assets (inside basis) corresponding to the high basis in the partnership interest (outside basis).
- <u>Practical effect</u>: Immediate gain recognition by the partners, but no immediate loss deduction by the creditor -- and ultimately the creditor loss may be capital in nature.

Liquidation Value Safe Harbor

- The parties may be allowed to use the liquidation value of the interest as the fair market value but are not required to. Reg § 1.108-8(b)(2)(i). The liquidation value safe harbor can be used only if:
  - The creditor, the partnership, and the partners all report consistently with the safe harbor.
  - All debt for equity exchanges that are part of the same overall transaction are treated consistently with the safe harbor.
  - The terms of the exchange are comparable to terms that unrelated third parties with adverse interests would agree to.
  - The partnership does not redeem the interest issued, and no person related to the partnership or the partners acquires the interest as part of a plan that had avoidance of COD income as a principal purpose.

Debt for Equity Example (Treas. Reg. § 1.108-8(c))



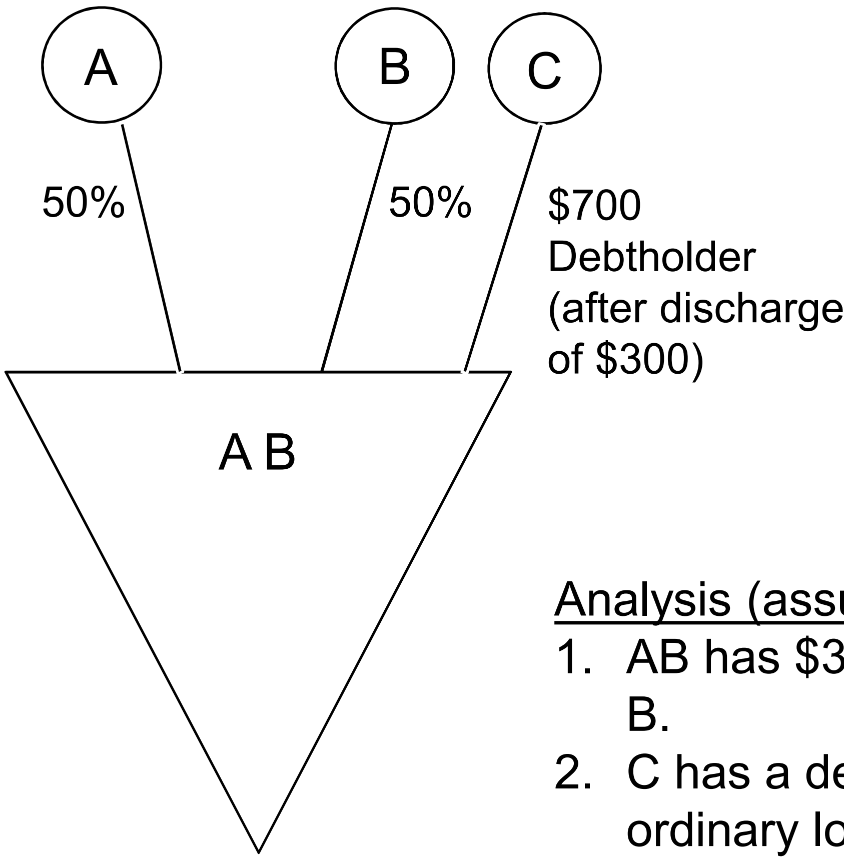
Facts:

1. AB owes C $1,000.
2. C exchanges the $1,000 debt for equity of AB.
3. If AB liquidated after the exchange, C would receive $700; assume liquidation value safe harbor applies.

Analysis:

1. AB has $300 of COD income, allocated to A and B.
2. C does not have a deductible loss, but has $1,000 basis even though the liquidation value of the equity is only $700.
3. If and when C's loss is eventually recognized, the loss is generally capital loss.

Debt for Equity Example – Debt Discharge in Advance



Facts:
1. AB owes C $1,000.
2. C writes off $300 of the debt.
3. C exchanges the $700 debt for equity of AB.
4. If AB liquidated after the exchange, C would receive $700; assume liquidation value safe harbor applies.

Analysis (assuming the form is respected):
1. AB has $300 of COD income, allocated to A and B.
2. C has a deductible loss, which may be an ordinary loss (depending on the application of Code § 166).

TAX ISSUES IN TRANSFERRING LLC AND PARTNERSHIP INTERESTS

By: Amanda F. Wilson
Shareholder
Lowndes, Drosdick, Doster, Kantor & Reed, P.A.
November 6, 2018

Potential Non-Taxable Transfers

Exchange for Corporate Stock

- A transfer of a partnership interest for corporate stock is generally a taxable exchange under §1001.

- Non-recognition treatment may be available under §351.

  - The partnership interest must be contributed to the corporation in exchange for stock of the corporation.

  - Transferors must be in control (at least 80 percent of the total combined voting power and at least 80 percent of the total number of shares).

  - Under §357(c), gain will be recognized if liabilities assumed by the corporation exceed the transferor's adjusted basis in all the property transferred. Consider impact of §752.

Conversions

- Conversions from one type of partnerships to another type are generally non-taxable.
- This includes conversions of a general partnership to a limited partnership or limited liability company where a partner obtains limited liability.
  - Watch out for shifts in a partner's share of liability under §752, as this can result in taxable income.
- Revenue rulings and private guidance include conversions involving GPs, LPs, LLCs, LLPs, and LLLPs.
- The IRS treats the conversions as distributions of the new interests to the converting partners in exchange for contributions of their old interests pursuant to §721.

Like-Kind Exchanges

- §1031 allows for non-taxable exchanges of like-kind property held for productive use in a trade or business or for investment.

- Partnership interests are specifically excluded from qualifying for §1031.
  - This exclusion does not apply if the partnership elected out of Subchapter K pursuant to §761(a).

- A partnership may enter into a like-kind exchange, for example, to exchange real estate with a third party.

Abandonment

- A partner that abandons a partnership interest for no consideration can take an ordinary loss in an amount equal to his basis in the partnership interest.
    - No consideration means that there is no sale or exchange under §1221, allowing ordinary income treatment.
    - However, if partner is relieved of liabilities under §752, the partner is treated as having received consideration. The result is the abandonment is treated as a sale of a partnership interest (a capital asset), and the <u>entire loss is capital</u> unless §751 provides otherwise.
    - However, ability to claim ordinary loss was temporarily impacted by <u>Pilgrim's Pride</u>, 141 T.C. No. 17 (2013), which was reversed by the Fifth Circuit in February, 2015.

Example

- Partner A has an outside basis in his 33.3% ABC partnership interest of $100. The assets of ABC have a basis of $300 and a FMV to $60. A is allocated no liabilities under §752.

- If A successfully abandons his interest in ABC, he would recognize $100 ordinary loss.

- Assume instead that ABC sells the property for $240 loss and liquidates. A would receive $20 cash and would be allocated a loss of $80 (1/3 of $240). This would generally be a capital loss.

- If even $1 of liability was allocated to A under §752, the entire $100 loss would be capital.

How to Abandon

- Abandonment of a partnership interest requires (1) an intention to abandon the asset, and (2) an affirmative act of abandonment.
- No specific steps are required.
- A written letter to the partnership stating that the partner is abandoning his interest has been approved by the IRS as a manner of establishing abandonment. Revenue Ruling 93-80.
- The terms of the partnership agreement may preclude abandoning a partnership interest.

Worthlessness

- The IRS has also held that a partner is entitled to an ordinary loss on the worthlessness of a partnership interest. Revenue Ruling 93-80.

- Worthlessness can be difficult to establish. The partner must show that the partnership interest has become worthless in the year that the loss is claimed.

Basis Adjustments

Basis Adjustments under §743

- §743(a) provides the general rule that the partnership's basis in its assets is not adjusted as a result of a transfer of a partnership interest.

- Where there has been a significant change in the value of the partnership property, there can be a large mismatch between the partner's proportionate share of the partnership's basis in its assets and the partner's basis in his partnership interest.

- Example: ABC partnership has assets with FMV of $3000 and basis of $300. X buys A's 33% interest for $1000. If ABC sells the assets, ABC will have $2700 of gain, $900 of which will be allocated to X.

§743(b) Adjustment

- Under §743(b), the basis of the partnership assets is adjusted with respect to the purchasing partner upon the sale or exchange of a partnership interest or the death of a partner.
    - Does not apply to contributions or distributions.
- §743(b) only applies if the partnership has made a §754 election or if there is a substantial built-in loss (greater than $250,000).
- Adjustment is only with respect to the purchasing partner, not the partnership.
- §743(b) adjustment is equal to the difference between the purchasing partner's initial basis in his partnership interest and his "proportionate share of the adjusted basis of the partnership property."

§743(b) Adjustment

- Considering the prior example:
  - X's proportionate share of the partnership's basis is $100.
  - X's basis in his partnership interest would be $1000.
  - §743(b) adjustment would be $900.
  - If ABC sold the assets for $3000, X would be allocated no gain from the sale because of the adjustment.
  - §743(b) adjustment is only with respect to X.

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§743(b) Adjustment

- There is a tension between existing and new partners with respect to whether make a §754 election.
- Once made, election cannot be revoked except with IRS consent.
- Applies to any subsequent sales or exchanges or transfers upon death, as well as distributions that trigger §734(b) adjustments.
- A technical termination revokes a §754 election. If the transfer results in the technical termination, the partnership can make a §754 election which would effectively apply only to that transaction.

§755 Allocation of §743(b) Adjustment

- Determine the FMV of all partnership assets.
- Determine the amount of income, gain or loss that would be allocated to the purchasing partner with respect to each partnership asset if all of the assets were sold for FMV.
- Classify the assets into ordinary income property and capital gain property.
- Allocate §743 adjustment to ordinary income classes to the extent that the total income, gain, and loss that would be allocated to the transferee with respect to the sale of ordinary income property in the hypothetical transaction.

§755 Allocation of §743(b) Adjustment

- Allocate §743 adjustment to capital gain classes to the partnership to the extent that the total income, gain, and loss that would be allocated to the transferee with respect to the sale of capital gain property in the hypothetical transaction.

- Limitation: Basis of capital gain property cannot be reduced below zero. The additional reduction must go to ordinary income property.

- Adjustments within classes are allocated first to properties with unrealized appreciation or depreciation to the extent of the purchasing partner's share. Remainder allocated in proportion to the purchasing partner's share of the amount that would be realized upon the hypothetical sale of each asset in the class.

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Basis Adjustments under §734

- §734(a) provides the general rule that the partnership's basis in its remaining assets is not adjusted as a result of a distribution to a partner.
- §734(b) provides for a basis adjustment where there is a §754 election in place or where there would be a substantial basis reduction (greater than $250,000).
- Unlike §743(b), this basis adjustment is common to all the partners.

Basis Adjustments under §734

- Basis increased in two situations:
  - Partner has recognized gain because he received a cash distribution in excess of his basis. Partnership can increase basis by the amount of the gain.
  - Partner receives distribution of assets where the partnership's basis in the assets exceeds the partner's basis in his partnership interest. Partner is limited to taking a basis in the assets equal to his basis in his partnership interest. Partnership may increase basis in remaining assets by the amount equal to the excess of the partnership's basis in the distributed assets over the partner's basis in his partnership interest.

Basis Adjustments under §734

- Basis decreased in two situations:
  - If a partner liquidates his interest solely for cash and unrealized receivables and inventory, he will recognize a loss to the extent of the excess of the partner’s basis in his interest over the sum of the cash and the partnerships basis in the unrealized receivables and inventory. The partnership reduces its basis by the amount of the loss.
  - If a partner's interest is completely liquidated and the basis of distributed assets in his hands is greater than the partnership's basis in the assets, the partnership reduces its basis in the remaining assets by the excess of the partner’s basis in the distributed assets over the partnership's basis in those assets.

§755 Allocation of §734(b) Adjustment

- The partnership determines the value of each of its assets.
- Assets are divided into capital gain assets and ordinary income assets.
- Determine the class of assets to which the §734(b) adjustment is allocated.
- Allocate the adjustment to the specific assets in the appropriate class.

§755 Allocation of §734(b) Adjustment

- If the adjustment is the result of an increase or decrease in the basis of distributed assets of a certain class, the basis of retained partnership assets of the same class is decreased or increased by a like amount.

- If the adjustment is a consequence of (a) the recognition of gain by the partner upon receipt of a distribution of cash in excess of his basis in the partnership or (b) the recognition of loss upon the complete liquidation of his partnership interest solely in exchange for money, unrealized receivables and inventory, the adjustment is allocated *entirely* to capital gain assets of the partnership.

§755 Allocation of §734(b) Adjustment

- Allocations within classes:
  - Increase allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation, then among all assets based on FMV.
  - Decreases allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation), then among all assets based on adjusted bases.

Collateral Issues

Sales that Terminate the Partnership

- A partnership automatically terminates if it has less than two partners.
- If the sale of a partnership interest results in a termination of the partnership, Revenue Ruling 99-6 treats that transaction as an asset purchase with respect to the purchaser.
    - There is a deemed distribution of assets to the selling partner, followed by an acquisition of the distributed assets by purchaser.
- A partnership automatically terminates if it has less than two partners.

Example

- A and B are equal partners in AB Partnership. A sells his 50% interest to B for $1000.
- A treats the transaction as a sale of his partnership interest.
- B receives a liquidating distribution of assets from the partnership for his 50% interest. B has a carryover basis in these assets and his holding period tacks.
- B then buys the remaining 50% interest in the assets from A. B has a basis in this 50% interest of $1000, and no holding period.

Technical Terminations (Pre-2018 Tax Years)

- §708(b)(1)(B) provides that there is a technical termination of a partnership if, within a 12-month period, there is a sale or exchange of 50 percent or more of the profits and capital interests in the partnership.
- Sales are aggregated, although multiple sales of an interest only counts once.
- Transactions with the partnership generally do not count. I.e., withdrawals, contributions or conversions. This provides significant planning opportunities.
- Gifts, bequests, or inheritances do not count.
- Can structure sales a year and a day apart to avoid termination.

What Occurs?

- Treasury Regulations §1.708-1(b)(1) provides that the following occurs upon a technical termination:

> The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership.

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General Consequences

- Because of Treasury Regulation §1.708-1(b)(1), the consequences are not as dire as under a prior version of the regulation.
  - Prior version deemed there to be a liquidating distribution of the assets to the partners, followed by a contribution of the distributed assets to a new partnership.
- Gain or loss is not triggered.
- Generally there are no consequences under §§704(b), 704(c), and 737.
- Partner's basis in the partnership remains unchanged, as does the holding period.

Traps for the Unwary

- Partnership's tax year closes, and partnership will have to file two returns.

- Elections are revoked and new elections must be made. This is often a reason to trigger a technical termination, especially if a §754 election is in place.

  - New EIN is <u>not</u> required.

- Depreciation is restarted, and the property is treated as "newly placed in service". This means a new useful life, which can stretch out depreciation over a longer period of time.

  - This is often the primary reason to avoid a technical termination.

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Allocations of Income

- If the selling partner disposes of his entire interest, the partnership's tax year closes with respect to that partner. If less than the entire interest is sold, the tax year remains open.

- Partnership income from before and after the sale must be allocated between the seller and purchaser.

- Available methods:

  - Interim closing of the books method - Items before sale go to seller, after to purchaser.

  - Pro rata method - Annual income allocated between seller and purchaser based on number of days in taxable year before and after sale.

Allocations of Income

- Other reasonable methods.

- Regulations suggest that the interim closing of the books method applies unless the partners otherwise agree.

- Proposed regulations issued in 2009.
  - Mandate that the interim closing of the books method is the default method.
  - Same method would have to be used for all variations in partnership interests during a given taxable year.

Drafting Issues

Drafting Issues

- Interest being transferred is the interest in the partnership, not in the underlying assets of the partnership.
  - Impact on transfer taxes, recording fees, etc.
- Representations and warranties typically go to the seller owning his interest free and clear of any and all liens, claims and encumbrances of any kind or nature whatsoever and seller having the right to transfer such partnership interest.
- Purchaser generally does not incur income tax liability for prior tax years (prior to 2018). Audits for prior years would result in adjustments to the returns of the partners in those years. Consider indemnity for 2018 on tax years.

Drafting Issues

- Partnership agreements often impose significant transfer restrictions, requiring consent of the GP, manager, managing member, etc. Transfers in violation of these restrictions may result in the transfer being void or the purchaser only acquiring assignee rights.

- Purchasing partner should be required to become a party to the partnership agreement.

- Address §754 election and how income will be allocated under §706(d). May require an amendment of the partnership agreement.

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THANK YOU

QUESTIONS?

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