Tax Issues in Sale of Partnership and LLC Interests


Outline

• Tax Classification of Partnerships and LLCs
• Tax Consequences in General to Seller and Buyer
• Sales of Interests in Tax Partnerships
• Partnership Mergers
• Sales of Interests in Disregarded Entities
I. Tax Classification of Partnerships and LLCs

- Eligible entities within the meaning of 301.7701-3
- Mechanics to achieve certain goals differ depending upon the tax classification of target
- Pre-closing structure alternatives

II. Tax Consequences

A. To Seller
   - Interest sale:
     - Capital gain or loss, except for “hot assets.”
     - Holding period generally determined by holding period of sold interest.
     - Installment method generally available
   - Asset sale:
     - Ordinary income/loss or capital gain/loss based upon particular assets sold.
     - Holding period determined by holding period of sold assets.
     - Installment method depends on assets sold.
   - Importance of purchase price allocation
   - Installment reporting generally available; but consider impact of hot assets.
II. Tax Consequences

B. To Buyer

• Buyer’s basis is cost, including assumed liabilities.

• Acquisition of assets results in basis in assets.

• Acquisition of partnership interest results in basis in the interest itself; absent 754 election (or built-in loss situation), the adjustment to the basis in the partnership interest is not matched by a basis adjustment in the hands of the partnership.

• Importance of purchase price allocation

C. Year of Sale Allocations

• Each of seller and buyer must be allocated company items for year that includes sale.
  - Methods are pro ration and closing of the books;
  - In some cases, closing of the books is mandatory.

• Tax distributions?

• Purchase agreement provisions
II. Tax Consequences

D. Miscellaneous Considerations
- Defining the transaction
- Tax return preparation
  - Elections
  - Tax year
  - Tax method of accounting
- Post-closing risk allocation

III. Sales of Interest in Partnership

A. Sale of less than 100%

Example:
- A is one-third partner in ABC LLC, a tax partnership and A’s interest has a basis of $3.
- ABC, a cash method partnership, has 3 fixed assets: (i) $3 of cash; (ii) a/r with a value of $9 and basis of $0; and (iii) equipment with a value of $9 and basis of $6 ($3 of depreciation previously claimed on equipment).
- D wishes to purchase A’s interest for $9.
- Assume purchase price allocated $1 to cash, $3 to a/r, $3 to equipment, and residual to goodwill.

1. The Transaction:
- A is selling an interest in a tax partnership representing less than 100% of the interests.

2. To A:
- As a sale of a partnership interest, sec. 741 provides for capital gain except to the extent of hot assets.
  - A’s total gain is $6 ($9 cash from D - $3 tax basis):
    - $4 of gain is ordinary as attributable to cash basis a/r and depreciation recapture.
    - $2 of gain is capital gain.

3. To D:
- $9 of basis in acquired interest
  - No step-up in ABC assets without a 754 election.
  - With 754 election, (i) basis of a/r becomes $3, (ii) basis of equipment becomes $7, and there is $2 of basis in goodwill.

4. Miscellaneous
- Allocation issues/Method of Accounting
- Purchase agreement; purchase price allocation/754 election/indemnity
III. Sales of Interest in Partnership

B. Contribution/Redemption of less than 100%

Example

• Assume same facts as previously slide, but instead of D buying directly from A, D contributes $9 to ABC for a preferred interest and ABC uses $9 to redeem A.

1. The Transaction:
   • Pursuant to 707(a)(2)(B), A is still considered as selling a less than 100% interest in a tax partnership directly to D.

2. To A:
   • Same consequences

3. To D:
   • Same consequences

4. Miscellaneous
   • There is now a change to parties to transaction; D is contracting directly with ABC and, due to nature of acquired interest, ABC operating agreement likely to be amended. Does this provide greater likelihood of control/access/etc?

III. Sales of Interest in Partnership

C. Sale of 100%

Example

• A and B each own 50% of AB LLC, a tax partnership.
• A sells all of its interest to B, so that B is the sole member.

1. The Transaction:
   • A is treated as selling a partnership interest. From B’s perspective, AB is deemed to liquidate by distributing assets to A and B, and then B is deemed to buy 50% of the assets from A. 99-6, Situation 1.

2. To A:
   • Capital gain except to the extent of hot assets.

3. To B:
   • Does deemed distribution result in taxable gain to B?
   • B’s basis in property deemed distributed is carryover (or B’s basis in equity, whichever is less). Holding period also tacked for 1231/capital gain assets.
   • B’s basis in assets in property acquired equals cost. Holding period begins from acquisition.

4. To AB
   • AB terminates; files final return.
IV. Partnership Mergers

- Definition: two or more partnerships at the beginning of the day, one at the end.
- Possible forms:
  - Interests over: Partners of one partnership contribute 100% of their interests to partnership two.
  - Assets up: Partnership one distributes all of its assets to its partners in liquidation, and partners contribute assets received in liquidation to partnership two.
  - Assets over: Partnership one contributes all of its assets to partnership two for partnership two interests, and then distributes partnership two interests in liquidation.
- 1.708-1(c):
  - Assets over is form unless parties actually undertake assets up.
  - Rules for direction of the merger (identify continuing partnership)
  - Be careful of triggering gain in these transactions.

V. Sales of Interests in Disregarded Entities

- A sale of 100% of the interests in a disregarded entity is treated as an asset sale by both parties for tax purposes.
- When less than 100% of the equity is sold, the disregarded entity becomes a tax partnership.
  - When units acquired from sole owner, seller is deemed to sell a portion of the assets to buyer, and then seller and buyer are deemed to contribute all of the assets to the entity in a partnership formation transaction. Rev. Rul. 99-5 situation 1.
  - When units acquired from the entity, buyer and other member deemed to contribute consideration plus assets of entity, respectively, to the entity in a partnership formation transaction. Rev. Rul. 99-5 situation 2.
  - If units acquired from the entity, but the entity immediately distributes the consideration to the other member, what is characterization?
    - Example: A owns 100% of LLC, which has A/R of $10 and goodwill of $6. B contributes $8 for a 50% interest, and LLC immediately distributes the $8 to A.
      - Rev. Rul. 99-5 situation 1?
      - 707(a)(2)(B)?
        - B is treated as contributing cash for equity.
        - A is treated as contributing a/R and goodwill to LLC in return for equity and $8 cash.