

Mastering Tax Complexities in the Sale of Partnership and LLC Interests

THURSDAY, JUNE 23, 2016, 1:00-2:50 pm Eastern

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June 23, 2016

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TAX ISSUES IN TRANSFERRING LLC AND PARTNERSHIP INTERESTS

June 23, 2016

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Overview

- Sale of Partnership Interest
 - General Rule
 - “Hot Asset” Rule
- Purchaser Issues
- Liquidating Distributions (Redemptions)
- Net Investment Income Tax – Application to Transfers of Partnership Interests
- Basis Adjustments

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:

$$\begin{array}{r} \text{amount received} \\ - \text{adjusted tax basis} \\ \hline = \text{gain (loss)} \end{array}$$

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 2012, Adam buys 10 units in Eden, LLC for \$200.
- In 2014, Adam buys another 10 units for \$1,000.
- In 2016, 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 types 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

Example: On 1/1/2016, 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 1/1/2006.

- 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 1/1/2016 (the cash contribution).
 - 67% of her LLC interest has a holding period that started on 1/1/2006 (the real property contribution).

Split Holding Period

- On 7/1/2016, 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 1/1/2016.
 - 67% of her gain (\$600) is treated as long-term capital gain because the holding period began on 1/1/2006.

“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.

“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.
4. Adjust total gain/loss to treat gain/loss on deemed sale of hot assets 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.

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

- Recharacterization
 - 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.

Purchaser Issues

- Basis of purchased interest
- Capital account
- Basis step up/down

Purchaser Issues

- Buyer's basis in newly purchased interest is equal to the amount paid plus the share of any liabilities assumed.
- If the seller was subject to 704(c), the buyer will generally succeed to this treatment.
- Buyer will also succeed to the seller's capital account.
- Adjustments to the basis of partnership assets as a result of a purchase can sometimes affect the allocation of liabilities.

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

Tax on Net Investment Income

- Various 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).
- Regulations provide guidance on the application of NIIT to these businesses, including definitions for the terms “financial instruments” and “commodities.”
- Under the 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.

Mastering Tax Complexities in the Sale of Partnership and LLC Interests

Lynn Fowler

Special Situations

- Partnership “mergers”
- Disguised sales of Partnership Interests
- Debt for equity exchanges

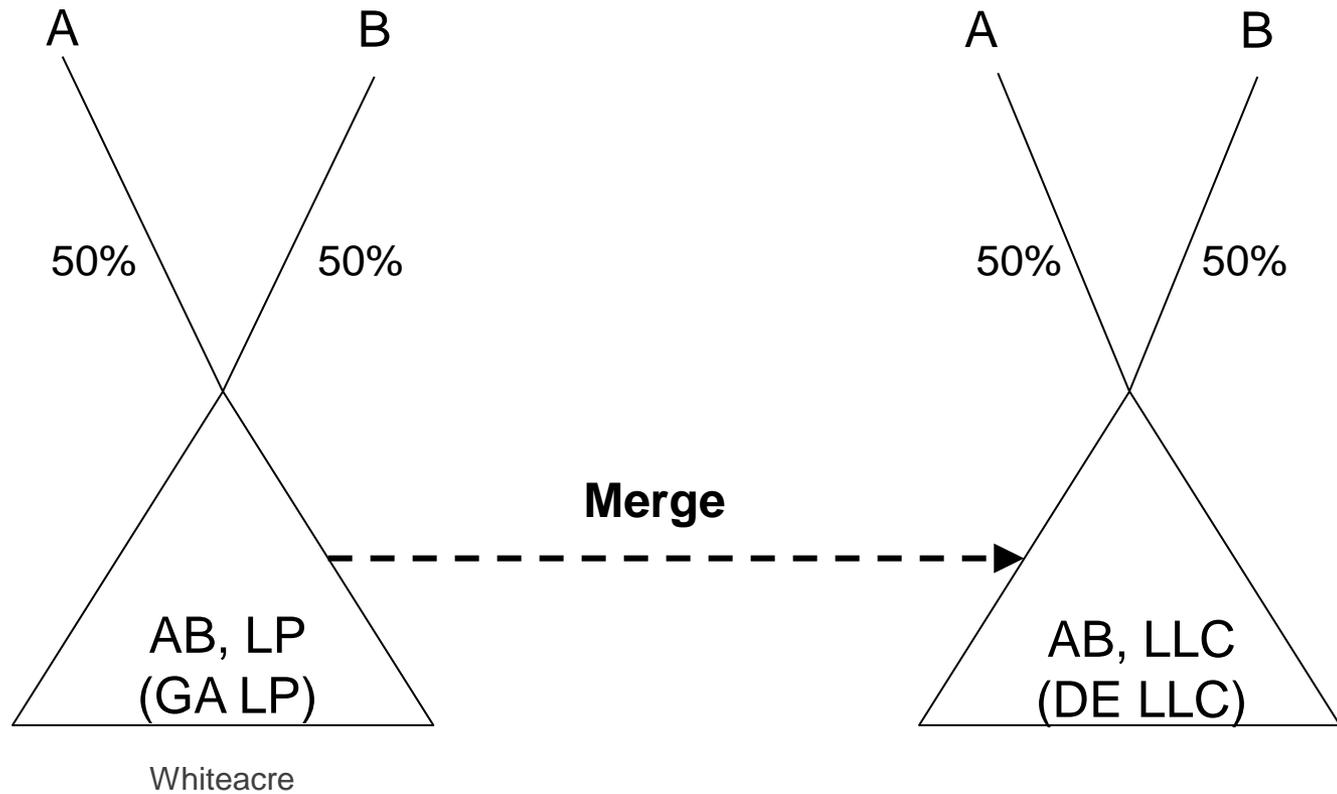
Partnership Mergers: What is a "Merger"?

- No statutory or regulatory definition of partnership merger
- However it is clear that:
 - Partnership merger does not rely on state merger statutes.
 - Partnership "merger" includes *many* transactions that are *not* undertaken under state merger statutes.
 - Partnership merger excludes many transactions
- Any time partnership transaction(s), with or without state law merger, result in fewer partnerships at the end than at the beginning, ask:
 - Has there been a partnership "merger" for tax purposes?

Example: State Law Merger Without Tax Merger

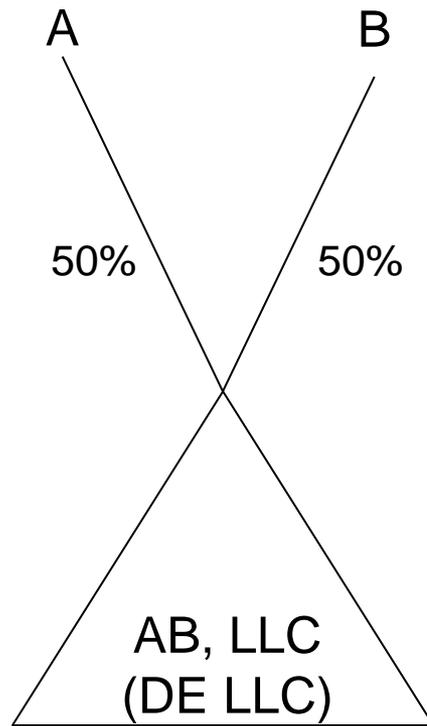
- Changing jurisdiction of entity or changing type of state law entity.
 - For example, changing a Georgia LP to a Delaware LLC might be accomplished by merging the existing LP into a new LLC under Georgia and Delaware law.
 - State law mergers of this kind are becoming less common now that many states 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 tax characterization. See Rev. Rul. 95-37, 1995-1 CB 130.

"Non-Merger" Example:



"Non-Merger" Example:

RESULT



Whiteacre

Federal Income Tax Analysis

- AB, LLC (DE LLC) is a continuation for tax purposes of AB, LP (GA LP).
- 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).
- Tax law would not distinguish between a state law merger into a shell and a state law conversion.

Equivalent Transactions

- **Tax law considers all of the following transactions to be identical**
 - State law merger of AB (GA LP) into AB (DE LLC).
 - State law 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).

Partnership Mergers: Which Partnership Survives?

- Code § 708(b)(2)(A) is the sole Code provision on partnership mergers.
 - Merely defines the survivor of a partnership merger.
 - Does not address consequences of partnership mergers, or even about what a partnership merger means.
 - The Code provision existed long before state laws provided for partnership mergers

IRC § 708(b)(2)(A)

"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)(B). See Treas. Reg. § 1.708-1(c).

Identification of Terminated and Continuing Partnerships

- 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 of the merged partnerships terminate. Treas. Reg. 1.708-1(c)(1).

Partnership Mergers = Distributions + Contributions

- A merger that is governed by the tax rules on partnership mergers is characterized as a combination of:
 - Contribution of assets of terminated partnership.
 - Issuance of interests of continuing partnership
 - Distribution to partners of terminated partnership.
- Distributions and contributions are often tax-free in the partnership environment. See IRC § 721; § 731
- Because the basic partnership rules on distributions and contributions are much more favorable than those for corporations, no need for the elaborate definitions of tax-free mergers found in the corporate tax context.

Partnership Mergers: Distribution Aspect

- Important 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.

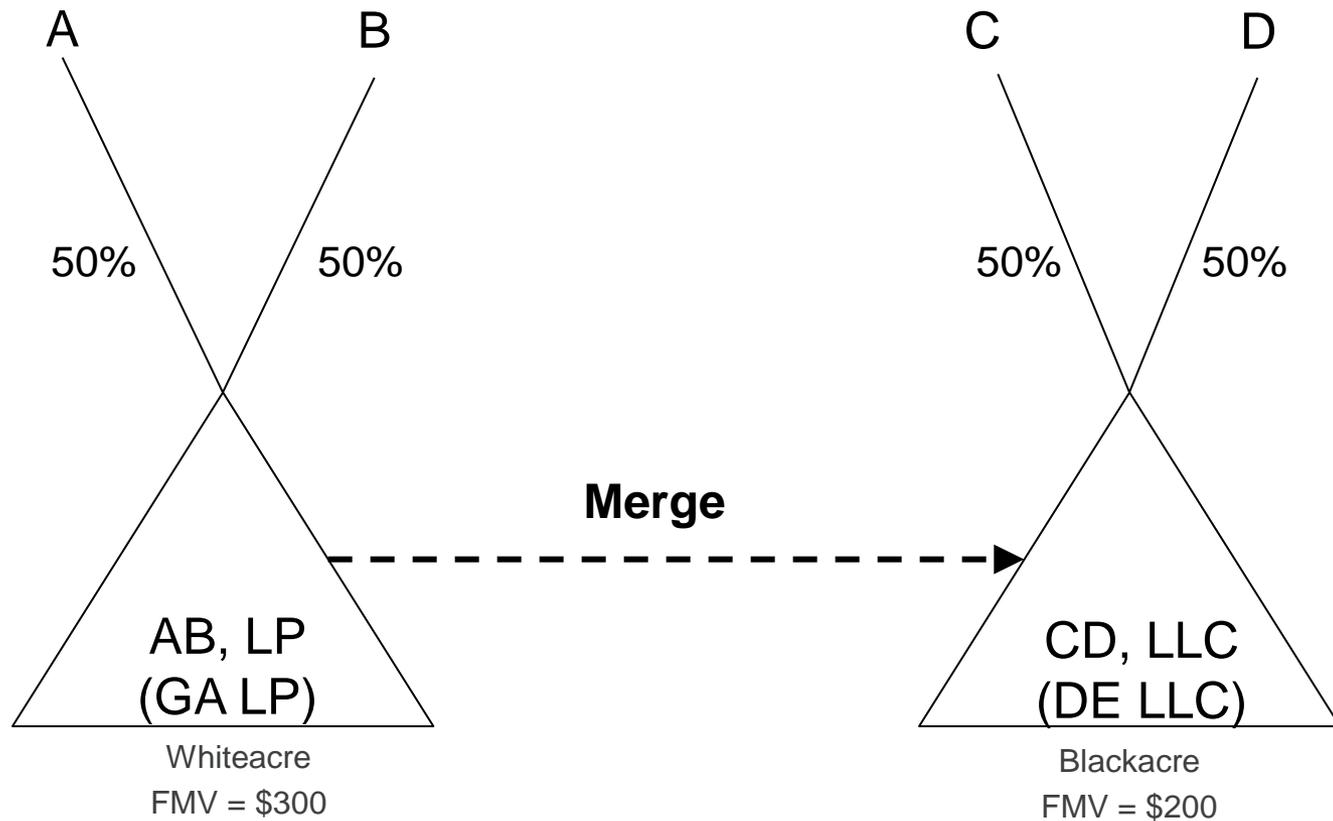
Partnership Mergers: Assets Over (Default Form)

- 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.

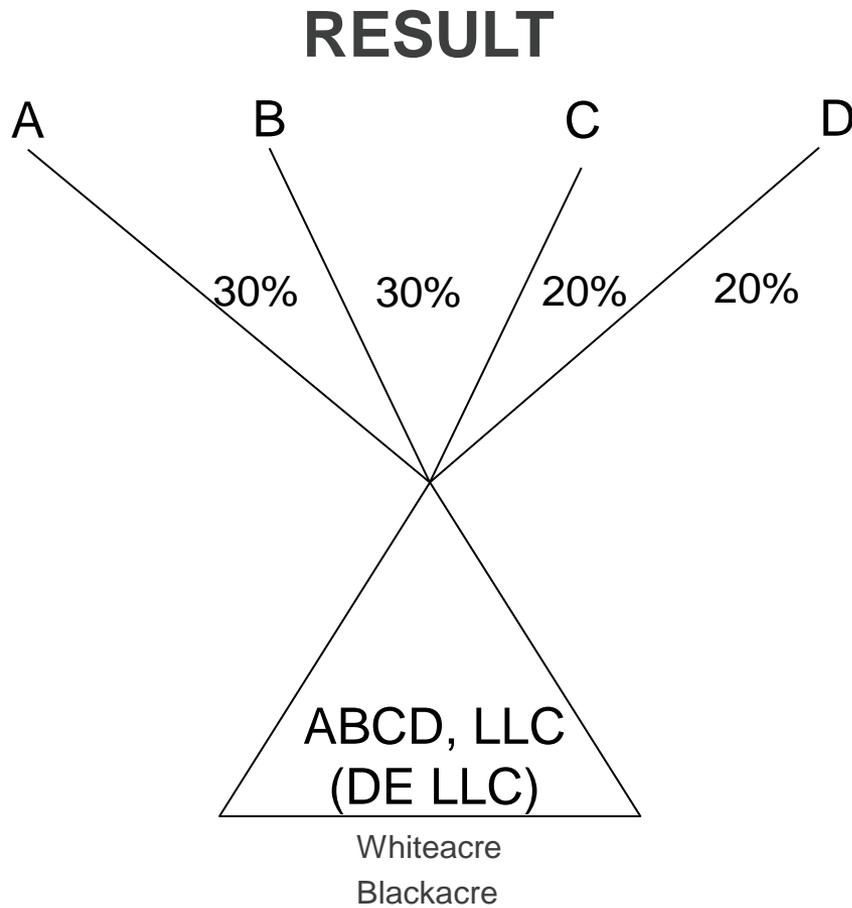
Partnership Mergers:

- 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.
- "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).

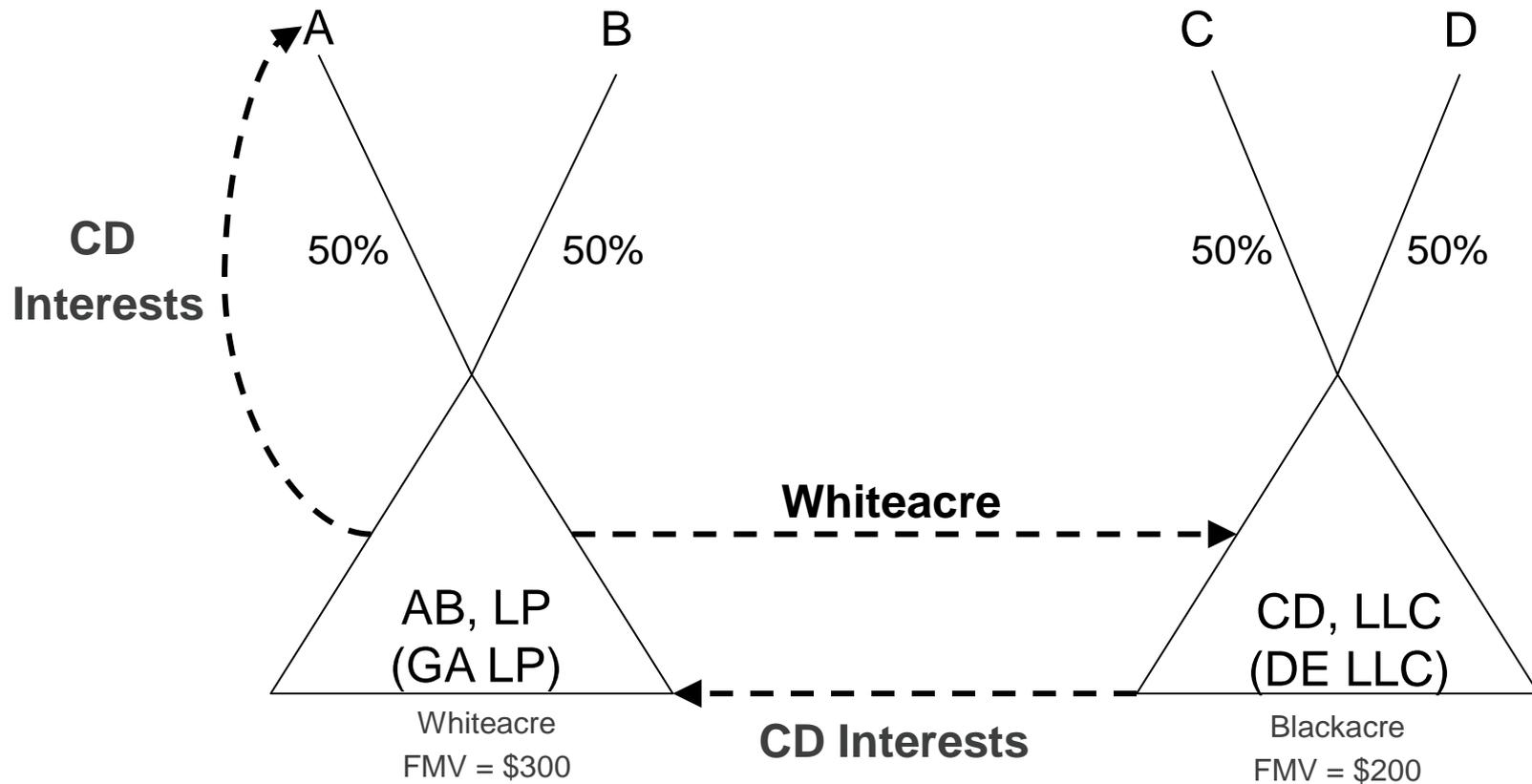
Merger Example:



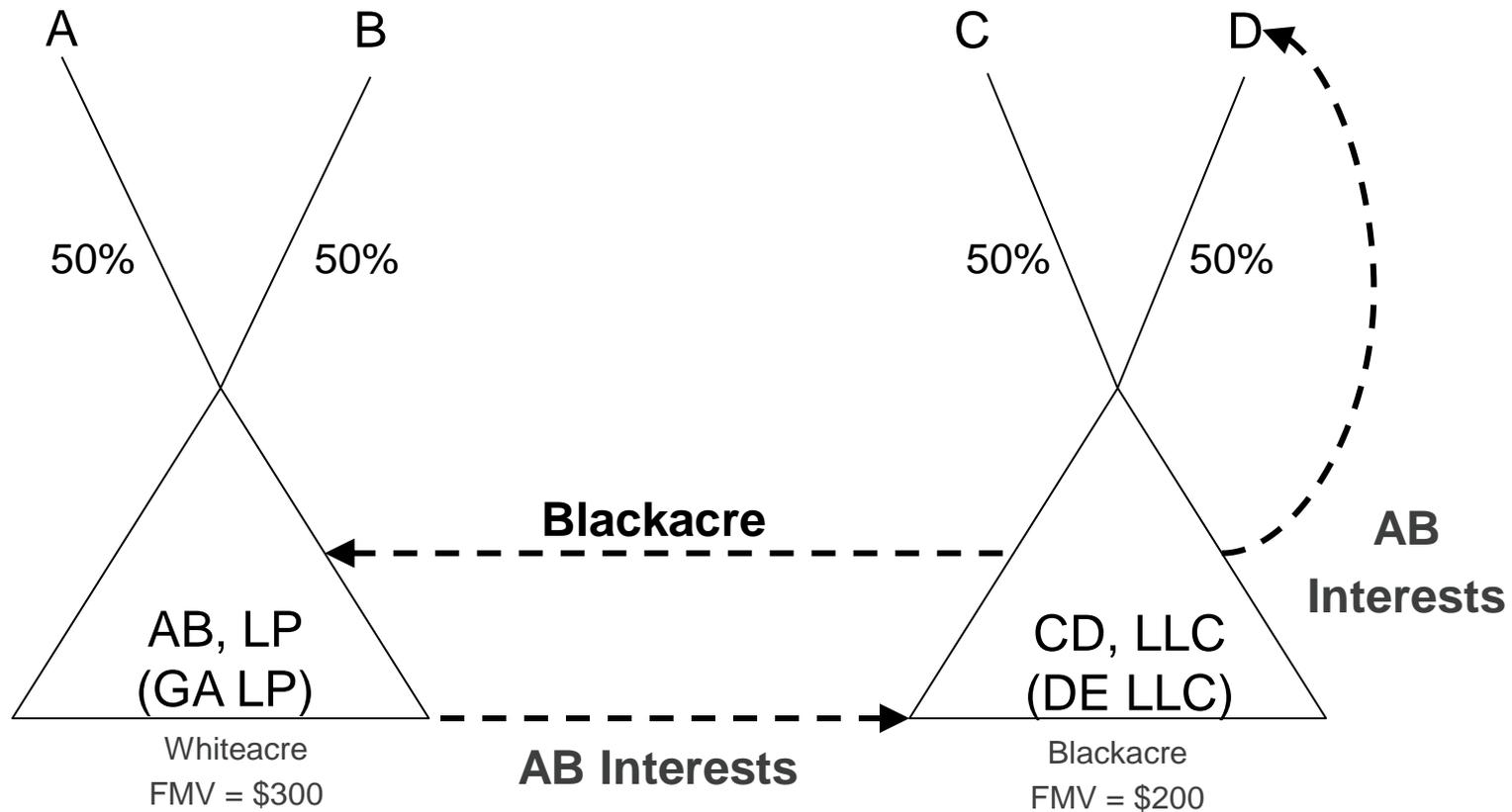
Merger Example:



Parties' Characterization of Transaction



Tax Law Characterization of Transaction



Seven Equivalent Transactions

- 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.

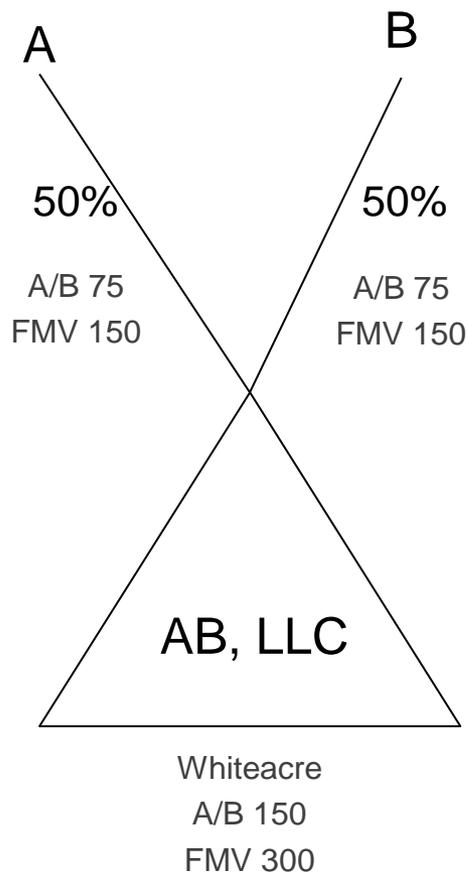
The Only Alternative

- 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 of Partnership Interests



A and B want to admit C as a 1/3 partner.

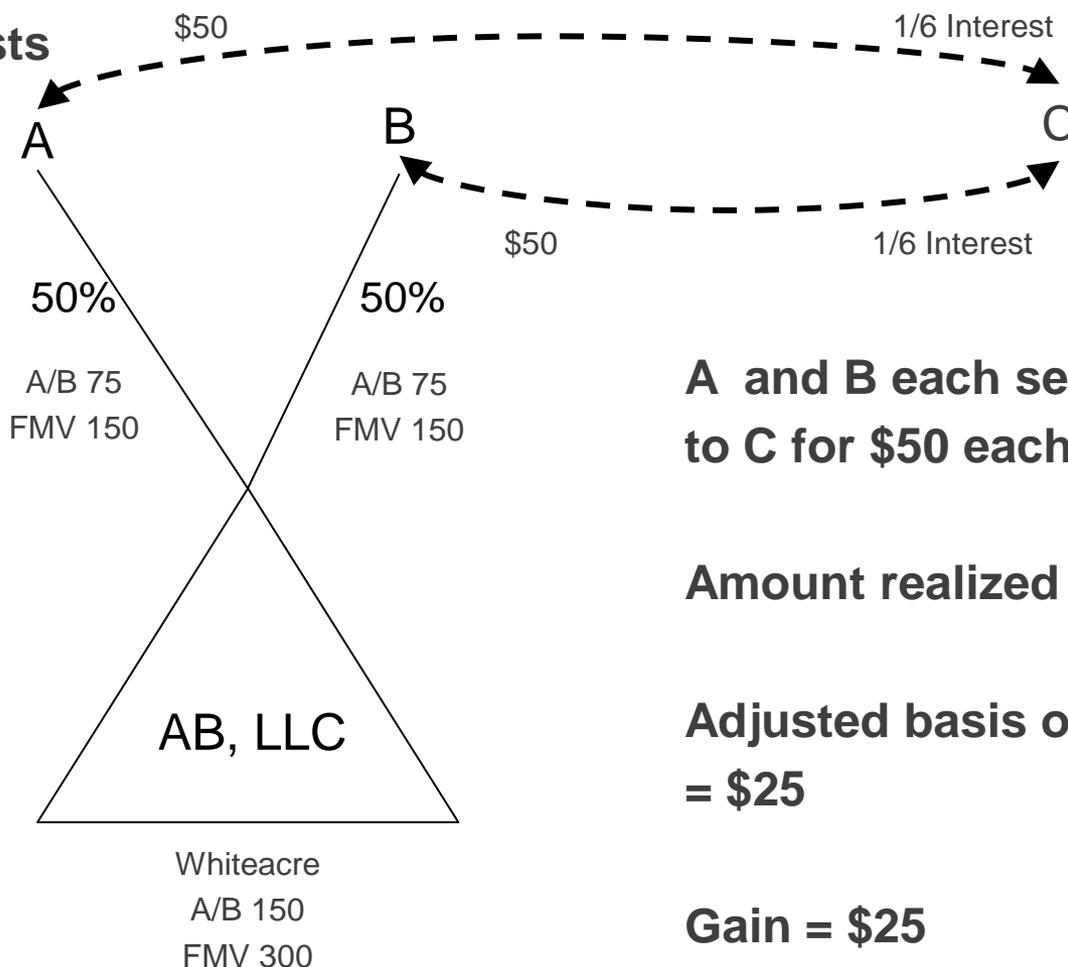
C will pay \$100 for his 1/3 interest

A and B will each receive \$50 for giving up a 1/3 interest

Disguised Sales of Partnership Interests

Alternative 1:

Sale of Interests



A and B each sell 1/3 of their interest to C for \$50 each.

Amount realized = \$50

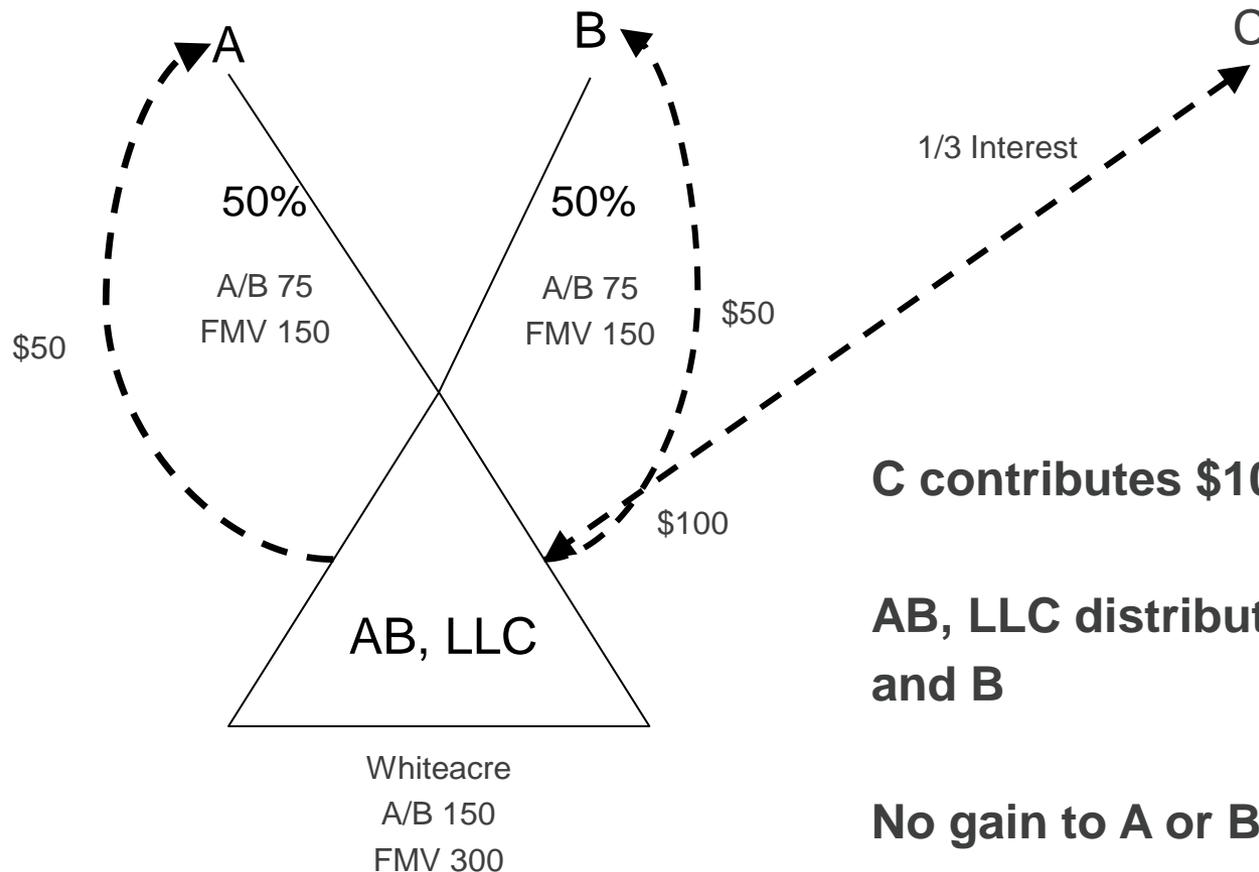
Adjusted basis of transferred interest = \$25

Gain = \$25

Disguised Sales of Partnership Interests

Alternative 2:

Contribution by C



C contributes \$100 to AB, LLC

AB, LLC distributes \$50 to each of A and B

No gain to A or B because distribution does not exceed basis

Disguised Sales

- I.R.C. § 707(a)(2)(B)
 - General rule: Transfer to a partnership is treated as a sale, rather than as a tax-free contribution, if:
 - A partner transfers money or other consideration to a partnership;
 - The partnership transfers money or other partnership to another partner
 - The two transfers are properly characterized as a sale or exchange of property

Disguised Sales of Partnership Interests

- 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.

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:
 - Would C have contributed the \$100 but for the \$100 distribution to A and B?
 - Would the partnership have distributed the \$100 to B but for the \$100 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.

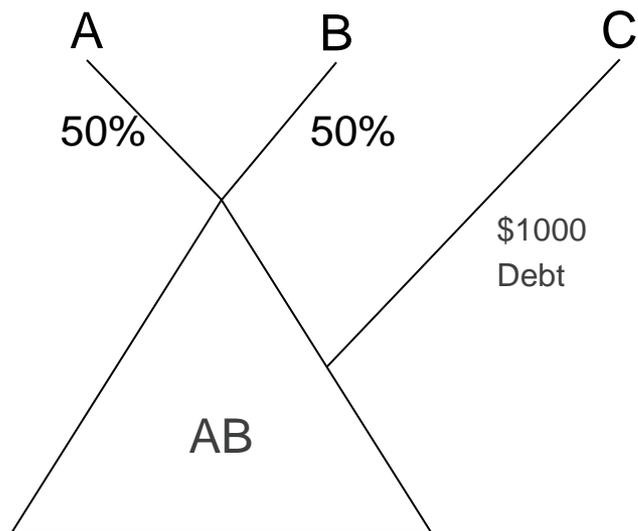
New Section 108 Regulations

- Final regulations on the contribution of debt by the creditor in exchange for a partnership interest were issued November 17, 2011 (TD 9557). 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.
- Lender does not recognize gain or loss. I.R.C. 721
 - 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).

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))



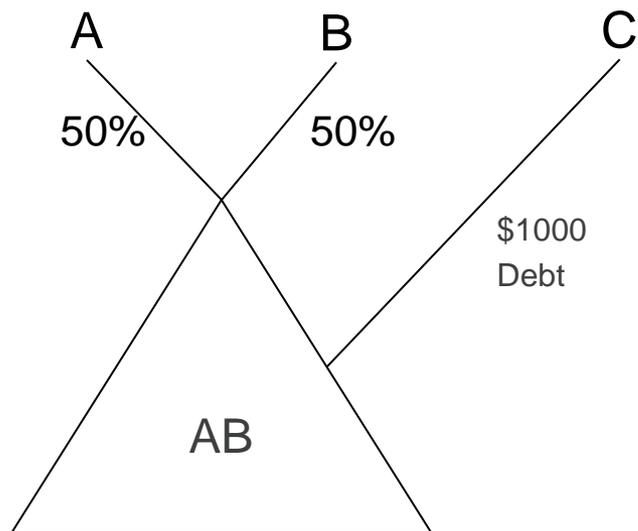
Facts:

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).

Basis Adjustments

Basic Problem

- In many instances, there can be a significant difference between inside and outside basis.
- Inside basis is the tax basis of a partner's share of the partnership's assets.
- Outside basis is the partner's tax basis in his or her partnership interest.
- Differences between inside and outside basis can create tax problems.

Example

- Smith, Jones and Dewey form Newco, LLC, by contributing \$100,000 each. They each hold equal shares in Newco. Newco uses the cash to buy property that later increases in value to \$600,000.
- Barlow pays \$200,000 to Smith to buy his interest in Newco.
- Immediately after the purchase, Barlow has a \$200,000 basis in his interest in Newco.
- Assume that shortly after the sale, Newco sells its sole asset for \$600,000.
- Newco recognizes gain of \$300,000 (purchase price of \$600,000 less tax basis of \$300,000). The gain is allocated equally to each member. Thus, \$100,000 is allocated to Barlow.

Example

- Newco then distributes the \$600,000 purchase price in equal shares to its members and liquidates. Thus, Barlow receives a \$200,000 cash distribution.
- At the end of the day, then, Barlow receives a \$100,000 allocation of income. This increases his outside tax basis from \$200,000 to \$300,000. He then receives a \$200,000 cash distribution, which reduces his outside tax basis from \$300,000 to \$100,000. Because Newco liquidates, the remaining basis is treated as a capital loss.

Example

- Barlow, then has a \$100,000 phantom gain (because there was no increase in value in Newco between the time Barlow purchased his interest and the time Newco sold its asset), and a \$100,000 phantom loss. It is possible that these will offset each other, but if the gain is ordinary income, Barlow may not be able to net it against the \$100,000 capital loss.
- Another inefficiency arises if the asset is depreciable. Barlow paid \$200,000 but at most will receive only \$100,000 in cost recovery deductions.
- The Code contains a special elective regime to address these problems.

Section 754 Election

- Code section 754 provides for a special tax election that permits a tax basis increase in certain situations that will ameliorate differences between inside and outside tax basis.
- In the foregoing example, if Newco had a section 754 election in place, then the tax basis of Barlow's share of the Newco asset would be increased from \$100,000 to \$200,000.
- Thus, Barlow would have no gain or loss on the sale described in the above example. Furthermore, to the extent the asset was depreciable, Barlow would be entitled to depreciation deductions based on the higher tax basis.
- If a partner dies, then the basis of his partnership interest adjusts to FMV. If there is a 754 election in place, the tax basis of the share of the partnership's assets represented by that interest is adjusted to reflect the new outside basis.

Built-In Loss Adjustment

- Although the basis adjustments described above are voluntary, the Code also contains mandatory basis adjustments.
- If there is a “substantial built-in loss” and there is a transfer of a partnership interest, then a mandatory basis reduction is required under Code §743.
- For these purposes, a built-in loss is substantial if the partnership’s tax basis in its assets exceeds the FMV by more than \$250,000.
- This rule is intended to prevent a partnership that has suffered a significant drop in value from selling off or trafficking in its unusually high inside basis.

Adjustments Related to Distributions

- Although basis adjustments can be triggered by the transfer of a partnership interest, distributions of property by the partnership can trigger gain or loss and therefore may create basis adjustment opportunities.
- IRC §734 permits or requires the partnership to adjust the basis of its property as a result of certain distribution events. Like §743, IRC §734 provides for a mandatory basis reduction in certain circumstances.
- The following paragraphs describe the four scenarios in which distributions can create opportunities for basis adjustments:

Adjustments Related to Distributions

Scenario 1: Gain on Distribution

- Gain is recognized by a partner upon a distribution if the partner receives money or marketable securities in an amount that is greater than the partner's outside basis.
- If the partnership has a 754 election in place, it is permitted to increase the basis of its remaining assets by the amount of gain recognized in such a distribution.

Adjustments Related to Distributions

Scenario 2: Lost Basis

- If a partner receives a distribution of property other than cash, the partner generally takes a basis in such property equal to the basis of the partnership. However, if that basis exceeds the partner's outside basis, a portion of the asset's basis disappears (i.e., it is reduced to come within the cap of the partner's outside basis).
- If the partnership has a §754 election in place, it can increase the tax basis of its remaining assets by the amount of the disappearing basis.

Adjustments Related to Distributions

Scenario 3: Loss on Liquidating Distribution

- If a partner receives a liquidating distribution of only cash or hot assets (or some combination of the same), then the partner can recognize a loss to the extent the partner's outside basis exceeds the amount of the cash and the basis of the hot assets.
- If the partnership has a 754 election in place, it must decrease the tax basis of its remaining assets by the amount of loss so recognized in such a distribution.

Adjustments Related to Distributions

Scenario 4: Additional Basis

- As noted, if a partner receives a distribution of property only than cash, the partner generally takes a basis in such property equal to the basis of the partnership . However, in the case of a liquidating distribution, if the partner's outside basis is greater than the partnership's basis in such property, the partner's basis in such property is increased to equal his or her outside basis.
- If the partnership has a 754 election in place, it is required to decrease the tax basis of its remaining assets by the amount of this additional basis.

Adjustments Related to Distributions

Mandatory Basis Adjustments

- Scenarios 3 and 4 occur only if a liquidating distribution occurs. If a section 754 election is in place, either scenario will require the partnership to decrease the tax basis of its remaining assets.
- However, even if there is no 754 election in place, if these scenarios give rise to “substantial” reductions, then the partnership must reduce the tax basis of its assets.
- For these purposes, “substantial” means
 - in the case of scenario 3, that a partner recognizes a loss of more than \$250,000 upon the liquidating distribution, or
 - in the case of scenario 4, that a partner increases the basis of property received by more than \$250,000.

Mechanics of the Election

- The 754 election is made by attaching a written statement to the partnership's tax return.
- The election must be filed no later than the legal due date of the return (including extensions).
- The election applies to all transactions occurring in the period covered by the tax return.
- After a partnership has made a 754 election it is binding for all subsequent periods.
- An election can only be revoked with the approval of the IRS.

Mechanics of Basis Adjustments

Section 743 Adjustments (Basis Adjustments Associated with Transfer of Partnership Interests)

- The process of allocating a basis adjustment in the case of §743 requires several steps.
- First, the basis adjustment is allocated between ordinary income and capital gain assets in accordance with the amount of gain or loss that would be allocated to the partner in a hypothetical distribution.
- Second, within each category, the basis adjustment as determined is allocated to individual assets in accordance with the amount of gain or loss that would be allocated to the partner in a hypothetical distribution.
- Note that this often results in negative and positive adjustments if there are assets with built in gain or loss, notwithstanding an overall positive or negative adjustment.

Mechanics of Basis Adjustments

Section 734 Adjustments (Basis Adjustments Associated with Distributions)

- Scenario 1: Gain on Distribution
 - positive adjustments are allocated only to capital gain assets
- Scenario 2: Lost Basis
 - positive adjustments are allocated only to assets of the same class as those distributed

Mechanics of Basis Adjustments

- Scenario 3: Loss on Liquidating Distribution
 - negative adjustments are allocated only to capital gain assets
 - however, the adjustment is limited to the basis of such assets
 - if the adjustment exceeds that basis, the difference is deferred until further assets are acquired

Mechanics of Basis Adjustments

- Scenario 4: Additional Basis
 - negative adjustments are allocated only to assets of the same class as those distributed
 - however, the adjustment is limited to the basis of such assets
 - if the adjustment exceeds that basis, the difference is deferred until further assets are acquired

TAX ISSUES IN TRANSFERRING LLC AND PARTNERSHIP INTERESTS

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