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Reporting Full and Partial Redemptions of Partnership and LLC Interests

IRC 754 Elections, Section 736(b) Payments, Character and Timing of Gain, Installment Sales, and More

TUESDAY, SEPTEMBER 19, 2017, 1:00-2:50 pm Eastern

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Reporting Full and Partial Redemptions of Partnership and LLC Interests

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ATTORNEYS AT LAW

Outline

- Partnership Distributions and Redemptions—General Rules;
- 751 “Hot Assets” in Redemption Transactions;
- 736(a) Payments to “General Partners”;
- Installment Sale Redemptions;
- Basis and 754 Elections;
- Stuffing Allocations; and
- Disguised Sales.

General Rules: Cash Distributions

- Tax-free to the extent of Partner’s outside basis.

- Cash distribution in excess of Partner’s outside basis is treated as gain from the sale of the partnership interest.
  - Cash includes marketable securities and net reduction of a partner’s share of liabilities.
    - Marketable Securities Exceptions:
      - Securities contributed by the partner;
      - Securities not marketable when acquired by the partnership;
      - Distributions by “investment partnerships” to “eligible partners”.

- No Loss Recognition on Non-Liquidating Distributions.

- Loss on Liquidating Distribution only in limited circumstance:
  - Only property received consists of cash, unrealized receivables, and inventory and the redeemed Partner’s outside basis exceeds the sum of money distributed plus the partnership’s basis in the distributed property.

General Rule: In-Kind Distributions (Other than Marketable Securities)

- **Non-Liquidating Distributions**:
  - Tax-Free
  - Carryover basis equal to lesser of (x) partnership's basis in distributed property or (y) partner's basis in partnership interest reduced by any money received in the same distribution.

- **Liquidating Distributions**:
  - Tax Free
  - Carryover basis equal to partner's basis in partnership interest reduced by any money received in the same distribution.

- **Carryover Basis Allocation among distributed properties**:
  - First to "inventory and unrealized receivables";
  - Next to other partnership assets:
    - First based on pre-distribution partnership inside basis;
    - Next, based on unrealized appreciation;
    - Remaining unallocated basis is allocated pro-rata based on fair market value.

Special Rule #1: Section 751 "Hot Assets"

751 Assets ("hot assets") Include:

- **"Substantially Appreciated Inventory"**
  - Substantial Appreciation means value in excess of 120% of the partnership's basis in the property.
  - In addition to actual inventory held for sale to customers in the ordinary course of business, "inventory" includes depreciable property used in a trade or business if held for one year or less.

- **"Unrealized Receivables"**
  - Includes cash-method accounts receivable and, for purposes other than Section 736 (discussed below), the ordinary income that would be recognized (under various provisions of the Code) upon the sale of:
    - Mining property
    - Stock in a DISC
    - Section 1245 property
    - Stock in certain controlled foreign corporations (as described in section 1248),
    - Section 1250
    - Franchises, trademarks, or trade names
    - Oil, gas, or geothermal property; and
    - Market discount bonds.

Section 751(b) – Deemed "Hot Asset Exchange"

- Goal is to determine extent to which a partner has changed its share of "hot assets" as a result of a distribution to prevent shifting of ordinary income.

- Operates through the creation of a constructive transaction whereby the change in the redeeming partner's share of hot assets is accomplished via a taxable transaction.
  - First, determine redeeming partner's share of (x) hot assets on the one hand; and (y) non-hot assets ("cold assets") on the other hand.

Section 751: Deemed Hot Asset Exchange Example 1

C owns 1/3 of partnership ABC. ABC's balance sheet is as follows:

Assets	Basis	Value
Cash	$15,000	$15,000
A/R	$9,000	$9,000
Inventory	$21,000	$30,000
PP&E	$42,000	$48,000
Land	$9,000	$9,000

Liabilities	
Current:	$15,000
Mortgage:	$21,000

Capital:	Basis	Value
A	20,000	25,000
B	20,000	25,000
C:	20,000	25,000

C's share of hot assets is 1/3 of the inventory ($10,000) and 1/3 of the A/R ($3,000) for total hot asset share of $13,000.

C's share of cold assets is 1/3 of the other property consisting of cash ($5,000), PP&E ($16,000) and Land ($3,000), for a total of $24,000.

Example 1(Continued)

C's interest is redeemed for $10,000 in cash and the distribution of $15,000 in depreciable property (with adjusted basis to the partnership of $15,000).

C's Tax Consequences:

- Prior to the transaction, C had an interest of $13,000 in hot assets (with a total basis of $10,000) and $24,000 in other property.
- After the transaction, C had an interest of $37,000 in other property and no interest in hot assets.
- As a result, C is treated as having first received a constructive distribution of hot assets with a basis of $10,000 and a value of $13,000.
- C is then treated as having sold the hot assets to the partnership for $13,000 of other property, recognizing $3,000 of ordinary income in the taxable exchange.
- Because C received no more than his share of land or depreciable property, but did receive more than his share of money, he is treated as having received money in the deemed exchange.
- C's original basis of $32,000 is thus reduced by the deemed $10,000 distribution to C of the hot assets to $22,000.
- Of the $22,000 in money he received ($10,000 in cash plus $12,000 in deemed distribution from the relief of the partnership liabilities), $13,000 is treated as having been received in the taxable exchange, such that only $9,000 reduces his outside basis to $13,000.
- As a result, he receives the depreciable property with a carryover basis of $13,000.

Partnership Tax Consequences:

- The partnership is deemed to have purchased C's share of the inventory and A/R for $13,000. This increases the inventory basis by the $3,000 of income recognized by C.
- As is discussed below, if a 754 election is in place, the reduction of basis in the depreciable property from $15,000 to $13,000 will give rise to an upward basis adjustment to the partnership's depreciable property of $2,000.

Example 2 (Continued)

Assume the same facts as the prior example, except that in liquidation, C receives $5,000 in cash and $20,000 in inventory with a basis of $14,000.

- Prior to the transaction, C had a $13,000 share of hot assets and $24,000 in other property.
- C's share of inventory has now *increased* by $7,000 and C's share of other property has *decreased* by $7,000.
- C is deemed to have received his share of each item of property $5,000 of cash, $16,000 of PP&E, $3,000 of land and $13,000 of hot assets. He is then treated as relinquishing his $16,000 of PP&E and $3,000 of land in exchange for $12,000 in money (liability relief) and $7,000 in additional inventory.
  - What did he exchange for the inventory??
  - Regulations allow the parties to agree to an allocation. If the parties agree that C relinquished $7,000 of PP&E for the inventory, he will be treated as exchanging 7/16ths of the PP&E (with basis of $6,125) for $7,000 of inventory. He will recognize gain of $875 and take the inventory with a $7,000 basis.
  - If the parties do not agree on a specific allocation, then the exchange will be deemed to have been made for a proportionate share of each property in which C relinquished an interest. Since he relinquished $7,000 of a total value of $19,000 ($16,000 of PP&E and $3,000 of Land), he would be treated as having purchased the inventory for 7/19ths of the PP&E value and 7/19ths of the land value.
- The partnership will recognize ordinary income on the sale of $7,000 in inventory, which had basis to the partnership of $4,900. Since the $7,000 of inventory was used to purchase a $7,000 interest in PP&E, the partnership will obtain a cost basis in the PP&E. That is, it will first decrease its PP&E basis by the $6,125 basis deemed distributed to C, and then increase its basis by the $7,000 deemed purchase price, resulting in a step-up in basis equal to the $875 of ordinary income recognized by C.

The 2014 Proposed Regulations

- Define a Partner's "share" of 751 property based on the ordinary income that would be allocated to that partner upon a sale of the assets of the partnership for their fair market value.
- This differs from the current Regulations' focus on each partner's share of the gross value of unrealized receivables.
- Instead of examining changes in a partner's share of "hot asset" value, would look to changes in a partner's share of ordinary income recognizable upon sale of partnerships for fair market value.
- Book-up of capital accounts would be used to determine each Partner's share of unrealized 751 income or loss.
- Would simplify the mechanics by allowing partnerships to choose among reasonable methods for allocations. Examples in the Regulations include reasonable methods for preserving each Partner's share of 751(b) income. While deemed exchange approach is one reasonable method, is not mandated in all cases.

Special Rule #2: Section 736(a) Payments to Retiring Partner

- In the case of a partnership in which capital is "not a material income producing factor," payments to a retiring or deceased "general partner" can be treated as a guaranteed payment or distributive share of partnership income to the extent attributable to:
  - Unrealized receivables (which, for this purpose, only includes cash-method accounts receivable and not recapture items); or
  - Goodwill, unless the partnership agreement provides for a payment in respect of goodwill.

- When is capital not "a material income-producing factor"?
  - Committee Report:

"[W]here substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice. In addition, the bill does not affect the deductibility of compensation paid to a retiring partner for past services."

Special Rule #2: Section 736(a) Payments to Retiring Partner

- Who is a "general partner"?
  - Unclear in LLCs.
  - Most actual general partners of limited partnership are themselves LLCs.
  - The position is generally taken that active members of service LLCs qualify as "general partners" for purposes of applying 736(a).
  - New partnership audit proposed regulations provide some guidance (albeit limited to a different context): Prop. Treas. Reg. 301.6223-1(e)(3):
    - "Solely for the purposes of applying this paragraph (e)(3) to a limited liability company (LLC) a member-manager of an LLC is treated as a general partner, and a member of an LLC who is not a member-manager is treated as a partner other than a general partner."

Application of Sections 736(a) and 736(b): Example

Example: Partnership ABC is a service partnership with the following balance sheet:

Assets	Basis	FMV
Cash	$13,000	$13,000
Unrealized Receivables	$0	$30,000
PP&E	$20,000	$20,000
1245 Recapture:	$0	$3,000

Liabilities
Debt: $3,000

Capital:	Basis	FMV
A:	$10,000	$21,000
B:	$10,000	$21,000
C:	$10,000	$21,000

Application of Sections 736(a) and 736(b): Example (Continued)

Partner A is a 1/3 owner and retires. He is entitled to $29,000. Thus, his total receipt is $30,000 ($1,000 in debt relief plus $29,000 in cash).

- First, figure out A's interest in 736(b) property. In this case, he has a total share of 736(b) property of $12,000 (1/3 of the value of the cash, PP&E and Recapture).
- Payments in excess of the $12,000 736(b) payment ($18,000) will be treated as guaranteed payments (because they are fixed in amount). ($10,000 of his share of Unrealized Receivables and $8,000 for goodwill.)
- The $12,000 in 736(b) payment includes a change in A's share of 1245 Recapture. Thus, the 751(b) rules must be applied to the 736(b) payment. A is relinquishing $1,000 of 1245 Recapture and receiving more than his share of cash. Thus, prior to the cash distribution, A will be treated as having received a distribution of 1245 Recapture with a basis of $0 and a value of $1,000. He is then treated as having sold the Recapture back to the partnership for $1,000 recognizing $1,000 of ordinary income.
- He will then be treated as having received a cash distribution of $11,000, reducing his $11,000 basis to $0.00.
- Partnership ABC will deduct as guaranteed payments the $18,000 736(a) payment, and will increase its basis in depreciable property by the $1,000 deemed paid for the Recapture asset.
- **Practice Note: The limitation on the definition of "unrealized receivables" for purposes of Section 736(a) to cash-method items was introduced to Section 751 and Section 736 in 1993. The 736 Regulations have not been updated. As such, practitioners should not rely on the examples in the 736 Regulations.**

Section 736 in LLC Agreements of Service Entities

- Many service LLC and LLP Agreements do not address characterization of buy-sell payments.
- The parties should discuss and agree on whether "premiums" paid to retiring partners (ostensibly for goodwill) should be treated as 736(a) or 736(b) payments. To the extent treated as 736(a) payments, the amounts will be recognized as ordinary income by the retiring partner and immediately deducted by the partnership. To the extent treated as 736(b) payments, the amounts will be capital gain to the retiring partner (and may give rise to a basis step-up to the partnership depending on whether a 754 election is in place).
- In some cases, 736(a) characterization will be the more tax-efficient means of achieving the same after-tax result.
- In most cases, the parties agree upon a pre-tax, rather than after-tax buyout payment. In that context, there may be tension between the desire on the part of the partnership to immediately deduct payments and the desire for capital gains on the part of the retiring partner.

Section 736 in LLC Agreements of Service Entities -- Example

Example:

- ABC intends to pay A an after-tax amount equal to $30,000 upon A's retirement. A's basis and interest in 736(b) property (other than goodwill) is equal to $5,000 (and there are no hot assets). There are no unrealized receivables.
- If the goodwill "premium" is treated as a guaranteed payment, and all of the partners of ABC (including A) pay tax on ordinary income at a 40% rate, ABC will have to pay A $46,667 to get him an after-tax amount equal to $30,000. The $41,667 deduction to ABC will have a tax benefit of $16,667 to the remaining partners, resulting in a net outlay by ABC of $30,000.
- If instead, the goodwill premium is treated as a payment in respect of goodwill, A will recognize capital gain upon the distribution in excess of his $5,000 basis. Assuming a 20% rate of tax, A will need $36,250 in order to wind up with $30,000 after tax. ABC will not get an immediate tax deduction for the $31,250 paid in excess of basis, but instead will, if a 754 election is in place, obtain an amortizable basis in the goodwill that is recovered over 15 years. Thus, even though a lower payment is made to A to achieve the same after-tax result, the immediate outlay by ABC will be greater if goodwill is treated as a 736(b) asset.

Deferred Payments v. Installment Sale

Benefit for deferred payment arrangements under §736 regulations

Deferred payment arrangements under Section 736 are treated as a distribution rather than a sale of partnership interests. This means that the redeemed partner is allowed favorable treatment on deferred payments received as compared to the sale context.

- *No Imputed Interest*: Section 736 payments are not subject to the imputed interest rules under Sections 483 or 1274.
- *Basis Recovery Permitted First*: Basis recovery does not need to be pro rata, as is the case in the installment sale context, and partner is permitted to recover basis first.
- *No §453 limitation*. Under section 453 the sales of certain assets are ineligible for installment sale treatment. There is no such limitation on deferred payments under Section 736.
- *Deferred Recognition of 752 Income*: Partner can defer relief from liability distribution until receipt of his or her last payment because he or she is still a partner. In the installment sale context, relief from liabilities may not be deferred and is recognized in the year of the sale.

Adjustment to Inside Basis

General Rule: Section 734(a) provides that a current or liquidating distribution does not trigger an adjustment to inside basis unless:

- the partnership has a Section 754 election in place; or
- there is a substantial basis reduction with respect to the distribution.

Potential for Basis Disparity: The general rule above can create a basis disparity because the general rule applies even when:

- the redeemed partner recognizes gain or loss on the distribution; or
- Section 732 applies to cause the basis of the distributed property in the hands of the redeemed partner to differ from its inside basis to the partnership.

Adjustment to Inside Basis (Cont'd)

Amount of the Adjustment : Section 734(b):

Increase adjusted basis of the remaining partnership property by:

- The amount of gain recognized by the redeemed partner; and
- In the case of a distribution which is outside basis limited under Section 732(a)(2) or is a liquidating distribution, the difference between the inside basis in the distributed property immediately before the redemption and the redeemed partner's basis in the property after the distribution
  - *If the distributed property is an interest in a lower tier partnership, this rule only applies if both the redeeming partnership and the lower tier partnership have made a Section 754 election*

Decrease Adjusted Basis of the remaining partnership property by:

- The amount of loss recognized by the Redeemed Partner in a liquidating distribution; and
- In the case of a distribution which increases the basis in the distributed property under 732(b) in a liquidating distribution, the difference between the partner's basis in the distributed property immediately after the redemption and the inside basis in the property immediately before the distribution.

Example: All Cash Redemptions

- **734(b)(i) Upward Adjustment**
  - A has a partnership interest with a basis of $10,000 and a value of $15,000. The partnership has no hot assets. A's entire interest is redeemed for $15,000 in cash. A recognizes $5,000 in gain. The partnership will increase its basis in its assets by the $5,000 in gain recognized by A.

- **734(b)(ii) Downward Adjustment**
  - A has a partnership interest with a basis of $10,000 and value of $5,000. The partnership has no hot assets. A's entire interest is redeemed for $5,000 in cash. A recognizes $5,000 in loss. The partnership will decrease its basis in its assets by the $5,000 in loss recognized by A.

Example: In Kind Redemptions

- **Upward 734(b)(i) Adjustment:**
  - A has a basis of $10,000 in his partnership interest and it has a fair market value of $15,000. In liquidation of his interest, he receives cash of $7,000 and depreciable property with an adjusted basis and fair market value to the partnership of $8,000.
  - The $7,000 cash distribution reduces A's basis in his partnership interest to $3,000. A then receives the depreciable property tax-free with a basis of $3,000.
  - The $5,000 excess of the property's $8,000 inside basis over its new $3,000 basis will increase the partnership's basis in its remaining assets.

- **Downward 734(b)(ii) Adjustment**
  - A has a basis of $10,000 in his partnership interest and it has a fair market value of $15,000. In liquidation of his partnership interest, A receives cash of $7,000 and property with an adjusted basis of $2,000 and fair market value to the partnership of $8,000.
  - As in the prior example, A's post-distribution basis in the property will be the $3,000 difference between A's outside basis before the distribution and the amount of money distributed to A in the distribution.
  - The $1,000 excess of the property's post-distribution basis over its pre-distribution basis will reduce the partnership's basis in its remaining assets.

Section 755 Allocation of Adjustment

Allocating the Section 734(b) Adjustment among Partnership Assets – Section 755

Step One: Divide the adjustment between

(i) ordinary income property; and

(ii) capital gain property

Step Two: Allocate the adjustment among the two classes.

- Rules similar to Section 734(c)
  - Positive adjustments:
    - first allocated to assets with unrealized appreciation (proportionately) to reduce or eliminate any inherent gain in the asset;
    - then the remaining amount divided among properties according to FMV
  - Negative adjustments:
    - Are first allocated to assets with unrealized depreciation effectively eliminating the inherent loss; and
    - then according to their adjusted bases (not fmv).

Stuffing Allocations

- Special tax allocation to reduce or eliminate outside gain or loss on cash redemptions.

- Common in hedge funds to provide current tax benefit to continuing investors (and avoid basis distortions (if no 754 election) or complex inside basis adjustments (if there is a 754 election)).

Example:

  - A has a tax basis in her partnership interest of $10,000 and a 704(b) capital account of $15,000. A receives a $15,000 cash distribution in complete redemption of her interest.
  - Pursuant to the partnership agreement, in the year of the redemption, A receives a special allocation of net (or gross) taxable income equal to $5,000. This results in an upward outside basis adjustment of $5,000, such that no gain or loss is recognized on distribution in redemption.
  - Instead of a deferred tax benefit in the form of an upward basis adjustment in its remaining assets, the remaining partners receive an immediate tax benefit via the diversion of taxable income to A.

- This practice is almost universally accepted in the hedge fund context, but many commentators question whether such an allocation meets the requirements for substantial economic effect (or represents an acceptable 704(c) methodology).
  - In securities partnerships, the more liberal rules allowing for full or partial netting allocations in respect of reverse 704(c) allocations provide many practitioners with comfort on this point.

Disguised Sales

- Distributions within two years of a contribution of property are, subject to certain exceptions, deemed disguised sales of property to the partnership.
- Sale date is the date of contribution.
- Consider installment sale rules, 707(b) re-characterization rules.
- Potential trap for the unwary.

Questions?

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