Sales vs. Redemptions of Partnership Interests

Follow the yellow brick road? Often, when a partner of a partnership is going to depart, there may be a choice as to whether the remaining partners will purchase the departing partner's interest on a pro rata basis or whether the partnership will redeem the interest. Under either approach, the departing partner ultimately will wind up with the same amount of proceeds and the remaining partners will wind up with the same percentage ownership interest in the partnership after the departure. However, depending on which road the parties take, the ultimate tax results can differ based on various detours along the way, and there can be visits with monkeys, poppies and even the wizard himself.

This article is a "think piece" for practitioners to consider when choosing between a sale and a redemption of a partnership interest, in situations in which the choice is there for the taking. It will discuss some of the issues to consider both from the departing partner's perspective and that of the remaining partners and the partnership. Readers may be surprised at some of the tax differences, particularly timing differences, that may result based on which road is taken.

Basic Framework for Discussion

For purposes of this article, we are going to consider the situation where Toto, Dorothy and the Wizard are equal members of Kansas LLC, a financial consulting firm. Toto has decided he wants to go for a run and retire at a time when the LLC has the following balance sheet:

	BASIS	VALUE
Cash	$ 100,000	$ 100,000
Cash-basis accounts receivable	0	450,000
FF&E (original cost—$400,000)	90,000	150,000
Building (original cost—$2,000,000)	800,000	2,690,000
Intangible value	0	1,200,000
	$ 990,000	$4,590,000
Mortgage debt	$1,590,000	$1,590,000
Members' capital accounts	(600,000)	3,000,000
	$ 990,000	$4,590,000

It is proposed that Toto be paid for his $1,000,000 interest in the LLC by means of the LLC borrowing $500,000 against the equity in the building and distributing such funds on retirement. The balance will be paid in five equal annual installments of $100,000 each, which the LLC expects to be able to pay from earnings. Toto and the LLC are analyzing the various choices of structuring the transaction and the tax implications to all parties of such choices.

At the outset, note that Toto's total income recognition (whether his interest is sold or redeemed) on the transaction eventually will be $1,200,000:

Cash consideration (including deferred payments)	$1,000,000

Liability relief (1/3 of $1,590,000)		530,000
Total amount realized		1,530,000
Basis:		
Negative capital account	$ (200,000)	
Share of mortgage (1/3 of $1,590,000)	530,000	
		330,000
Gain		$1,200,000

The $1,200,000 of gain will be attributable to the following items (ignoring any potential imputation of interest in the case of a sale or exchange, as discussed below):

Ordinary income items:		
Cash-basis accounts receivable	$ 150,000	
FF&E recapture	20,000	
		$ 170,000
Capital gain items:		
Potential section 1250 capital gain (1/3 of $1,200,000 depreciation taken):	$ 400,000	
Remaining capital gain on building	230,000	
Gain on intangible value	400,000	
		1,030,000
		$1,200,000

As noted above, in many circumstances, there is little or no difference in the economic consequences between a sale or a redemption of a partnership interest. For example, under the foregoing facts, whether Toto's interest is sold in equal pieces to Dorothy and the Wizard or whether the LLC redeems Toto's interest, Dorothy and the Wizard wind up as equal members. However, there are numerous differences in the tax consequences of the exit transaction, depending on whether the transaction is structured as a sale or a redemption of Toto's membership interest. If the parties desire to structure the transaction as a sale or exchange of a membership interest, the form of the transaction generally will be respected by the IRS. On the other hand, if the parties desire to structure the transaction as a redemption of a membership interest, the form will not always be respected, as the IRS may attempt to recharacterize the redemption as a disguised sale of a partnership interest.

The Disguised Sale Rules

The place to start in the analysis of the tax differences between a sale and a redemption of a partnership interest is to determine whether, if the parties structure the transaction as a redemption as described above, the transaction will be respected as such for federal income tax purposes. The determination of whether the transaction is respected as a redemption is a function of whether the disguised sale rules of Code Sec. 707(a)(2)(B) would apply to recharacterize the redemption as a sale or exchange of a partnership interest. Code Sec. 707(a)(2)(B) has been in the Code since 1984. In its most elementary form, the disguised sale rules can recharacterize a contribution of appreciated property to a partnership followed by a distribution of other partnership property to the contributing partner as a disguised sale of the contributed property, rather than as tax-free partnership contribution and distribution transactions. Treasury issued fairly comprehensive and complicated regulations under Code Sec. 707(a)(2)(B) (the "Disguised Property Regulations") on September 25, 1992. However, Reg. §1.707-7, which is entitled "Disguised sales of partnership interests," was reserved. That is not to say that the IRS did not believe that a contribution to an existing partnership combined with a distribution to an existing partner could not be recharacterized as a sale of a partnership interest before any regulations were issued. In fact, several years ago, the IRS issued a few private letter rulings determining that a disguised sale of a partnership interest had occurred. *See*, *e.g.,* FSA 200024001 and TAM 200037005.

The reason for the more than 20-year delay in the issuance of proposed regulations addressing disguised sales of partnership interests likely is the complexity in distinguishing between what should be a tax-free property contribution/distribution transaction and what should be considered a disguised sale of a partnership interest. The Senate Finance Committee Report ("Report") relating to the Tax Reform Act of 1984 (at CCH p. 831) indicated that Congress anticipated that such regulations would be issued:

> It is anticipated that the regulations will apply the provision when the transfer of money or other property from the partnership to the partner is related to the transfer of money or other property to the partnership in such manner that, taking into account all the facts and circumstances, the transaction substantially resembles a sale or exchange of all or part of the property (<u>including an interest in the partnership</u>). (Emphasis added.)

However, the Report also contained the following caution:

> In prescribing these regulations, the Treasury should be mindful that the committee is concerned with transactions that attempt to disguise a sale of property and not with non-abusive transactions that reflect the various economic contributions of the partners. Similarly, the committee does not intend to change the general rules concerning the tax treatment of the partners under sections 721, 731, and 752 to the extent (1) contributed property is encumbered by liabilities not incurred in anticipation of the contribution, or (2) contributions to a partnership which, because of liabilities of the partnership incurred other than in anticipation of the contribution result in a deemed distribution under sec. 752(b).

On November 26, 2004, Treasury finally issued proposed regulations addressing disguised sales of partnership interests (the "Proposed Regulations"). Despite Congressional warning, the Proposed Regulations create a framework that may call into question vanilla property contribution/distribution transactions. The starting point in the analysis is Prop. Reg. §1.707-7(a)(1), which provides:

> Except as otherwise provided in this section, if a transfer of money, property or other consideration (including the assumption of a liability) (consideration) by a partner (purchasing partner) to a partnership and a transfer of consideration by the partnership to

> another partner (selling partner) are described in paragraph (b)(1) of this section, the transfers are treated as a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner.

However, the critical provision is Prop. Reg. §1.707-7(b)(1), which provides:

> A transfer of consideration by a purchasing partner to a partnership and a transfer of consideration by the partnership to a selling partner constitute a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner <u>only if</u>, based on all the facts and circumstances—(i) The transfer of consideration by the partnership to the selling partner would not have been made <u>but for</u> the transfer of consideration to the partnership by the purchasing partner; and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. (Emphasis added.)

Note that the Proposed Regulations did not adopt the "double but for" test that would find a disguised sale of a partnership interest only where <u>both</u> the transfer to and the transfer by the partnership would not have been made but for the other transfer.

Just as in the Disguised Property Regulations, the Proposed Regulations contain a two-year presumption. That is, Prop. Reg. §1.707-7(c) provides that "if within a two-year period a purchasing partner transfers consideration to a partnership and the partnership transfers consideration to a selling partner (without regard to the order of the transfers), the transfers are presumed to be a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfers do not constitute a sale." On the other hand, Prop. Reg. §1.707-7(d) provides that "if a transfer of consideration by a purchasing partner to a partnership and the transfer of consideration by the partnership to a selling partner (without regard to the order of the transfers) occur more than two years apart, the transfers are presumed not to be a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfers constitute a sale." (*See* Prop. Reg. §1.707-7(b)(2) which sets forth ten relevant facts and circumstances that Treasury regards as tending to prove the existence of a sale.)

A transfer is considered to take place on the date of the actual transfer or, if earlier, on the date that the transferor agrees in writing to make the transfer. The sale of the selling partner's partnership interest is considered to take place on the date of the first to occur of the selling partner's receipt of consideration from the partnership or the transfer of consideration to the partnership by the purchasing partner. Prop. Reg. §1.707-7(a)(2)(ii)(A). This rule is not too difficult to apply when there is a simultaneous transfer of consideration by the purchasing and selling partners to and from the partnership. However, the deemed sale rules become far more difficult in application in the case of non-simultaneous transfers or when the property distributed to the selling partner is different than that contributed by the purchasing partner. The Proposed Regulations contain a whole litany of rules addressing these situations.

For example, assume the selling partner receives a distribution from a partnership in year one and the purchasing partner makes a contribution to the same partnership in year two. Assuming the transactions do not fall within one of the exceptions from disguised sale treatment (listed in the disclosure rule discussion below), and the facts and circumstances cannot be shown to establish that the transaction should not be recharacterized as a disguised sale (*see* Prop. Reg. §1.707-7(b)(2)), Prop. Reg. §1.707-7(a)(2)(ii)(C) provides that the following is deemed to have occurred:

> …[T]he partners and the partnership are treated as if, on the date of the sale, the purchasing partner transferred an obligation to deliver the purchasing partner's consideration to the partnership in exchange for the selling partner's consideration and then the purchasing partner transferred the selling partner's consideration to the selling partner in exchange for all or a portion of the selling partner's interest in the partnership. On the date of the actual transfer of the purchasing partner's consideration, the purchasing partner and the partnership are treated as if the purchasing partner satisfied its obligation to deliver the purchasing partner's consideration to the partnership.

In other words, a person who may not even exist at the time of the distribution (e.g., a yet-to-be formed investment partnership) is deemed to have purchased an interest from the selling partner, even though the purchasing partner has not transferred anything to the partnership and has not received anything from the partnership. Problems also exist in the converse situation where, for example, the purchasing partner makes a contribution to a partnership in year one and there is a distribution from the partnership in year two that does not satisfy any of the exceptions from disguised sale treatment. Prop. Reg. §1.707-7(a)(2)(ii)(D) provides in such a situation that the following is deemed to occur:

> …[T]he partners and the partnership are treated as if, on the date of the sale, the purchasing partner transferred the purchasing partner's consideration to the partnership in exchange for an obligation of the partnership to deliver the selling partner's consideration and then the purchasing partner transferred that obligation to the selling partner in exchange for all or a portion of the selling partner's interest in the partnership. On the date of the actual transfer of the selling partner's consideration, the selling partner and the partnership are treated as if the partnership satisfied its obligation to deliver the selling partner's consideration to the selling partner.

The Proposed Regulations contain special rules that apply to shifts in partnership liabilities. Under the Proposed Regulations, an <u>assumption</u> of a partner's liability by a partnership or another partner automatically is treated as a transfer of consideration to the partner. On the other hand, it <u>appears</u> under the Proposed Regulations that borrowing against the <u>equity</u> of property, followed by the use of the proceeds to effectuate a redemption, may not be a disguised sale.

In analyzing the impact of financing used to effectuate a redemption, note that Prop. Reg. §1.707-7(j)(1) provides that deemed contributions to and distributions from a partnership because of a reallocation of liabilities under Code Sec. 752 are not inherently treated as a transfer of consideration in a sale transaction. However, the Proposed Regulations go on to provide that this rule does not apply, if the transaction otherwise is treated as a disguised sale under the concepts contained in the Proposed Regulations. In other words, if there is a disguised sale, liability relief is included in the amount realized. But, where is the consideration provided by Dorothy and the Wizard? They have not provided any of their own consideration, and the LLC merely has borrowed against the equity in the property. It also should be noted that Prop. Reg. §1.707-7(j)(8) contains an anti-abuse rule, which provides that an increase in a partner's (e.g., Dorothy's and the Wizard's) share of a partnership liability may be treated as a transfer of consideration, if (i) within a short period of time after the partnership incurs the liability one or more partners (e.g., Dorothy and the Wizard) bears an economic risk for the liability that is disproportionate to the partner's interest in partnership profits or capital, and (ii) the transactions are undertaken to minimize the "extent to which the partner is treated as making a transfer of consideration to the partnership that may be treated as part of the sale under this section." (Emphasis added.) But once again, where is the transfer of consideration by Dorothy and the Wizard?

Even if there is deemed to be consideration provided by Dorothy and the Wizard because of the debt shift after the redemption, the Proposed Regulations still contain an exception to disguised sale treatment. Prop. Reg. §1.707-7(e) provides:

> (e) Transfers of money in liquidation of a partner's interest presumed not to be a sale. Notwithstanding the presumption set forth in paragraph (c) of this section, for purposes of this section, if a partnership transfers money, including marketable securities that are treated as money under section 731(c)(1), to a selling partner, or is treated as transferring consideration to the selling partner under paragraph (j)(2) of this section, in liquidation of the selling partner's interest in the partnership, the transfer is presumed not to be a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfer is part of a sale. See §1.761-1(d) for the definition of the term liquidation of a partner's interest. (Emphasis Added.)

The preamble to the Proposed Regulations describes the above presumption against disguised sale treatment in the case of a complete liquidation of a partner's interest as follows:

> The IRS and the Treasury Department believe that the abuse that section 707(a)(2)(B) was intended to address typically is not present in situations involving complete liquidations of partners' partnership interests for money. Accordingly, the proposed regulations provide that, notwithstanding the presumption relating to transfers within two years, a transfer of money, including marketable securities that are treated as money under section 731(c)(1), to a selling partner in liquidation of that partner's entire interest in the partnership is presumed not to be part of a disguised sale of that interest. However, the IRS and the Treasury Department recognize that there are instances in which a liquidating distribution may properly be characterized as part of a disguised sale of a partnership interest, particularly when the tax consequences of a liquidating

distribution are significantly different from those of a sale of a partnership interest. Accordingly, the presumption against sale treatment may be rebutted in those cases.

Example 6 of Prop. Reg. §1.707-7(l) is the only example of the operation of the presumption against disguised sale treatment for the complete liquidation of a partner's interest in a partnership. The example posits a partnership that receives a contribution of money from a new partner and there is a simultaneous complete redemption of a partner's interest in the partnership via a distribution of marketable securities having a value equal to the cash contribution, which securities are treated as money under Code Sec. 731(a)(1). The Proposed Regulation indicates that the redemption would be presumed to be a disguised sale, but for the liquidation exception under Prop. Reg. §1.707-7(e), which causes the redemption to be presumed not to be a sale unless the facts and circumstances clearly establish otherwise (even though "property" was contributed to the partnership and taken out of the partnership within a period of two years). The Proposed Regulation cautioned, however, that if one of the exceptions under §731(c)(3) applied to treat the distribution of the marketable securities as property other than money, then the presumption against sale treatment would not apply.

The example is quite simplistic and may seem to imply that cash in followed by cash out (a transaction that certainly looks like a disguised sale of a partnership interest) will be respected as a redemption where the partner is being completely redeemed. However, based on the preamble set forth above, this appears not to be the case. It may be that the IRS will try to rebut the presumption any time a different tax result is obtained via a redemption and there are factors that could put the transaction within the ambit of the disguised partnership interest sales rules. For instance, it would not be surprising if the IRS tried to assert disguised sale treatment where there is (i) a difference in the character of income recognition, such as will be explained later in this article when addressing the differing treatment with respect to consideration attributable to intangible value, (ii) a different holding period result for assets that are later sold (which can be long-term where a redemption is respected in the case of a redemption of one of two partners in a two-person partnership), (iii) a different section 1250 capital gain result where the underlying property is depreciable real estate subject to the special 25% tax rate, or (iv) in the case of a redemption of a 50% or more partner, where a sale would terminate the partnership under Code Sec. 708(b)(1)(B) and require depreciation to begin anew. However, under the facts set forth above, given that (i) the LLC is borrowing against its own equity, (ii) Dorothy and the Wizard are not assuming any personal liability on the financing and (iii) the non-sale presumption operates in the members' favor, there is a significant possibility that redemption treatment should be sustained.

Lastly, note that whether the presumption works in favor of or against a taxpayer does not mean that non-sale treatment cannot be established. The concept (contained in the Proposed Regulations) of liability relief being part of sale proceeds, which is a concept also contained in the Disguised Property Regulations, has always been somewhat controversial insofar as the conflict between the regulations and a taxpayer's ability to refinance his own property on a tax-free basis. In other words, a partnership can refinance its property and distribute the proceeds to its partners on a tax-free basis (assuming the partner has sufficient debt in basis to receive the distribution, which is always the case when the property is refinanced on a nonrecourse basis). It is also well-established that a partnership redemption of a partner often results in the remaining partners having the same economic ownership post-redemption as they would have if they had purchased the partnership interest of the partner being redeemed, but the tax consequences between a sale and redemption can be different and the partners generally have a right to choose between a sale and redemption.

It also is important to note that the Proposed Regulations add an enhanced disclosure rule to the disguised sale regulations. New Prop. Reg. 1.707-7(k) provides:

> (k) Disclosure rules. Disclosure to the Internal Revenue Service in accordance with §1.707-8 is required when a partner transfers consideration to a partnership and the partnership transfers consideration to another partner within a seven-year period (without regard to the order of the transfers), the partners treat the transfers other than as a sale for tax purposes, and the transfer of consideration by the partnership is not presumed to be a guaranteed payment for capital under §1.707-4(a)(1)(ii), is not a reasonable preferred return within the meaning of §1.707-4(a)(3), and is not an operating cash flow distribution within the meaning of §1.707-4(b)(2). However, disclosure is not required under this paragraph if an exception provided in either paragraph (a)(8) (relating to transfers resulting from a termination of a partnership under section 708(b)(1)(B) and transfers incident to the formation of a partnership) or paragraph (g) (relating to transfers to and by service partnerships) applies to either of the transfers. (Emphasis added.)

Consequently, even if one concludes under the facts set forth above that the LLC has the presumption working in its favor, the above Proposed Regulation may require disclosure of the transaction; although the disclosure obligation is not entirely clear, given the lack of clarity as to whether the liability shift is a transfer of consideration (as there has been no actual assumption of the liability).

While the new disclosure rule does not change the two-year presumption, when finalized (assuming in its present format) it would require reporting of a plethora of garden-variety distributions occurring within seven years of unrelated contributions. (Also note that the disclosure rule would apply not only to "potential" sales of partnership interests, but also to a "potential" disguised sale emanating from a contribution of property to a partnership.) Consequently, tax preparers will be faced with the daunting task of keeping track of all contribution and distribution transactions for a running 7-year period and analyzing whether something occurring up to seven years in the past must be reported. Note that the extension of the disclosure rules from the 2-year period contained in the Disguised Property Regulations to 7 years likely was designed to apprise the IRS of potential Code Sec. 704(c)(1)(B) or Code Sec. 737 transactions (given that the statute of limitations may have passed for disguised sale transactions).

The Intangible Value Distinction

Perhaps the most significant tax difference between a sale and a redemption of a partnership interest in a personal services partnership is the treatment of intangible value (i.e., goodwill and going concern value). If Toto's departure were either structured or treated as a sale or exchange of a membership interest, the $400,000 portion of the consideration treated as in exchange for the LLC's intangible assets would be treated as capital gain to Toto and would create an asset that would be amortizable by the remaining LLC members over 15 years (subject to potential application of the anti-churning rules contained in Code Sec. 197(f)(9) in circumstances not relevant here, a subject that is beyond the scope of this Article), assuming the LLC makes a Code Sec. 754 election or has one in effect. On the other hand, in the case of a redemption of Toto's membership interest, the parties likely have a choice as to the tax characterization of the $400,000 portion of the redemption payment treated as attributable to the LLC's intangible assets.

Except in the case of "personal service partnerships," a redeemed partner recognizes capital gain to the extent the redemption payment is attributable to intangible value of the partnership, and, if a Code Sec. 754 election is made or is in effect, the partnership will amortize the "acquired" intangible value over 15 years—effectively the same result for all involved in the case of a sale or exchange of a partnership interest.

However, as a remnant of pre-1993 Tax Act law, Code Sec. 736(b)(3) provides that a partnership redemption payment that (1) is attributable to goodwill of the partnership, which is not specified as such in the partnership agreement, and (2) is paid by a partnership (referred to by many as a "personal service partnership") in which capital is not a material income-producing factor and is paid to a general partner in the partnership, is generally deductible by the partnership and ordinary income to the recipient. The IRS has not yet ruled on the characterization of an unallocated payment attributable to the goodwill of an LLC, which is paid to a retiring LLC manager or actively participating LLC member. However, the "body language" of Treasury in the self-employment arena, where it wants to put LLCs and partnerships on equal footing, appears to suggest that the Code Sec. 736(b)(3) choice should be available to a "personal service" LLC. Perhaps also of significance as to how a court might view Code Sec. 736(b)(3), if the IRS were to take an unfavorable position, is *Gregg v. United States*, 2001-1 USTC ¶50,169 (D. Ct. Oregon), where the court allowed an LLC manager to qualify for the seven "general partner" material participation tests under the Code Sec. 469 passive loss regulations, rather than the three "limited partner" material participation tests.

Note that personal service partnerships tend to try to structure retirement payments under Code Sec. 736(b)(3), i.e. ordinary income for the recipient and an ordinary deduction for the partnership. The reason is that there is a desire to be able to correlate the deduction with the cash outflow and to allocate the deduction to the persons who were the partners in the years in which the payment is made.

Lastly, note that retirement payments under Code Sec. 736(a) generally are treated as self-employment income (which needs to be factored into part of the decision-making process as to the capital gain/ordinary income decision on a redemption of a partnership interest). However, retirement payments are excluded from self-employment tax pursuant to Code Sec. 1402(a)(10) and Reg. §1.1402(a)-17, if:

1. The payments are made on a periodic basis by a partnership pursuant to a written plan that provides for payments on account of retirement to partners generally or to a class or classes of partners to continue at least until the partner's death (to qualify as payments on account of retirement, the payments must constitute bona fide retirement income; generally, retirement benefits are measured by, and are based on, such factors as years of service and compensation received);

2. The retired partner to whom the payments are made rendered no services with respect to any trade or business carried on by the partnership (or its successors) during the taxable year of the partnership (or its successors), which ends within or with the taxable year of the partner, in which the payment was received;

3. No obligation exists (as of the close of the partnership year referred to in 2. above) from the other partners to the retired partner except with respect to retirement payments under the plan or rights such as benefits payable on account of sickness, accident, hospitalization, medical expenses, or death; and

4. The retired partner's share of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year referred to in 2. above.

Sometimes, in situations such as illustrated in this article, the LLC will try to structure the payment stream to fall within the Code Sec. 1402(a)(10) exclusion. To do so, it becomes necessary to pay for Toto's entire capital account at closing, and to isolate the payments for the LLC's intangible assets as part of the deferred payments. For example, the LLC might consider restructuring the payment stream to pay Toto $600,000 for his interest in the LLC's assets and to pay for the $400,000 portion attributable to the LLC's intangible assets under the deferred payment structure. As discussed in more detail below, this flexibility in designating what each payment is for is available under the Code Sec. 736 regulations. It would then become necessary to pay Toto for the rest of his life in order to meet the Code Sec. 1402(a)(10) requirements. This commonly is done by adding a nominal payment for the rest of Toto's life, in addition to the $400,000 of payments made on the installment basis for the agreed upon amount for the intangible assets. For example, a structure that paid a retiring partner $100 per month for life, after the completion of the "real" payment stream, has been approved as a lifetime payment stream by the IRS in at least two private letter rulings in the past few years. *See* PLR 200403056; PLR 200142004.

The Section 1250 Capital Gain Difference

Reg. §1.1(h)-1(b)(3)(ii) provides a look-through rule in the case of a sale or exchange of a partnership interest, requiring the seller to recognize section 1250 capital gain equal to the amount of such gain that would have been allocated to the seller, if the underlying property were sold in a fully taxable transaction. However, the same regulation provides there is no look-through in the case of "a transaction that is treated, for Federal income tax purposes, as a redemption of a partnership interest." Consequently, if the transaction in this article is structured as a redemption and is not treated as a disguised sale of a partnership interest, Toto would avoid

25% taxation on the $400,000 portion of the gain attributable to his share of depreciation taken with respect to the building.

Unclear is what happens to Dorothy and the Wizard as a result of Toto avoiding section 1250 capital gain recognition. Recall that at the time of Toto's redemption, there is $1,200,000 of built-in section 1250 capital gain and $690,000 of residual capital gain. The IRS has not issued any guidance as to how the a Code Sec. 734(b) basis adjustment is allocated between the section 1250 capital gain element and the residual capital gain element. Some tax professionals have suggested that the $400,000 Code Sec. 734(b) basis adjustment should serve to reduce the $1,200,000 section 1250 capital gain element, as Dorothy and the Wizard only received $800,000 of depreciation deductions. However, it is unlikely that the IRS would adopt such a position. More likely, the IRS's view would be that the price the remaining members of the LLC pay for structuring Toto's exit as a redemption is that they step into his shoes insofar as section 1250 capital gain is concerned. Under this approach, the only time that a redemption would not result in the remaining members taking a tax hit would be where the property is being sold at a price where there is no residual capital gain (i.e., the sale price does not exceed the basis of the property plus an amount equal to the section 1250 capital gain element).

Note that if the transaction were structured or treated as a sale or exchange of a membership interest, it is unclear whether the section 1250 capital gain is required to be reported before the residual capital gain or is reported on a pro rata basis. Reg. §1.453-12(a) provides that where there is unrecaptured section 1250 capital gain in an installment sale, the unrecaptured section 1250 capital gain is recognized first. However, this regulation does not address the sale of a partnership interest on an installment basis, where the partnership holds section 1250 capital gain property. Reg. §1.1(h)-1(b)(3)(ii) provides that in the case of a sale of a <u>partnership interest</u>, even though the interest itself is not depreciable property, there is a look-through rule that requires the seller to recognize the amount of section 1250 capital gain that would have been allocated to him had the property been sold by the partnership; from the standpoint of installment reporting, the only relevant statement contained in Reg. §1.1(h)-1(b)(3)(ii) provides as follows:

> If less than all of the <u>realized</u> gain is recognized upon the sale or exchange of an interest in a partnership, the same methodology shall apply to determine the section 1250 capital gain recognized by the transferor, except that the partnership shall be treated as transferring only a proportionate amount of each section 1250 property determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. [Emphasis added.]

What perhaps is unclear from this language is whether it is intended that the section 1250 capital gain and the residual capital gain can be prorated when there is an installment sale of a partnership interest, or whether the language is merely referring to a situation where a partner has sold less than his entire partnership interest. The former may well be the correct interpretation because in an installment sale less than all the <u>realized</u> gain is being recognized with each payment; in the case of a partial sale of a partnership, all realized gain is recognized.

There is a comment in TD 8902, which implemented the final regulations under Code Sec. 1(h), that could be read to provide that the focus of the language above was on the partial sale of a partnership interest and not on installment reporting. In a section addressing a comment that was made regarding the regulations when they were in proposed form with respect to the allocation of gain or loss under Code Sec. 704(c), Treasury made the following observation:

> Certain commentators requested that the final regulations provide guidance with respect to the proportionate part of the section 704(c) built-in gain or loss that is transferred to the purchaser when a section 704(c) partner sells a portion of a partnership interest. This issue is relevant because, in determining a taxpayer's share of collectibles gain or section 1250 capital gain on the sale of a partnership interest, it is necessary to calculate how much of such gain would be allocated with respect to the partnership interest sold if the underlying collectibles or section 1250 property held by the partnership were sold for their fair market value. <u>In making this determination where a partner sells only a portion of its interest in a partnership, it is necessary to determine how much section 704(c) gain relating to collectibles or section 1250 property is allocable to the portion of the partnership interest that is sold</u>. Although relevant, Treasury and the IRS believe that this issue is beyond the scope of these regulations. Accordingly, this comment is not addressed in these regulations. (Emphasis added.)

This language, while not per se addressing the issue presented in this article, <u>could</u> be read to suggest that Treasury was focusing on partial sales and not installment sales. In any event, the issue is far from clear, and additional IRS guidance is needed.

Method and Timing of Hot Asset Income Reporting

Code Sec. 453(i) provides that any "recapture income" must be reported in the year of disposition of the property and cannot be reported on the installment method. The term recapture income is defined in Code Sec. 453(i)(2) as any income that would be ordinary income under Code Sec. 1245 (or so much of Code Sec. 751 that relates to Code Sec. 1245). Consequently, if Toto's transaction were a sale or exchange of a membership interest, the $20,000 of Code Sec. 1245 recapture with respect to the FF&E could not be reported on the installment basis. However, it is unclear if the $150,000 of income attributable to the cash-basis receivables, can be reported on an installment basis. For a further discussion of this issue, *see* the Partner's Perspective column in the CCH Partnership Tax Planning and Practice Guide at ¶9723.

Note that if the LLC had inventory (in which case it would not have cash-basis receivables and payables, because it would be on the accrual method of accounting), the IRS takes the position that any income attributable to the inventory cannot be reported on the installment basis in the case of a sale or exchange of a membership interest. Rev. Rul. 89-108, 1989-2 CB 100. Even though Code Sec. 451(i) does not refer to inventory items, the IRS applies an aggregate theory in the revenue ruling, looking through the partnership's assets and concluding that installment reporting is not available because a partnership would not be able to report the sale of inventory on the installment method. The IRS's conclusion was based on legislative history to Code Sec. 751, which it summarized as follows:

> Section 751 of the Code was enacted to prevent the conversion of certain potential ordinary income into capital gain upon the sale or exchange of a partnership interest. This section, in effect, severs certain income items from the partnership interest. Thus, to the extent a partnership interest represents substantially appreciated inventory or unrealized receivables described in section 751, the tax consequences to the transferor partner are "the same tax consequences which would be accorded an individual entrepreneur." In effect, the transferor partner is treated as disposing of the property described in section 751 "independently of the rest of his partnership interest." (Citations omitted.)

The IRS concluded that the import of this legislative history was to treat a sale of a partnership interest on an aggregate basis, stating that "because section 751 effectively treats a partner as if the partner had sold an interest in the section 751 property of the partnership, the portion of the gain that is attributable to section 751 property is reportable under the installment method only to the extent that income realized on a direct sale of the section 751 property would be reportable under such method." Because a sole proprietor could not sell inventory on the installment method pursuant to Code Sec. 453(b)(2)(B), the IRS ruled that installment reporting was not available with respect to the income attributable to the selling partner's share of the "substantially appreciated inventory" of the partnership.

There is some question as to whether Rev. Rul. 89-108 is correct. In its recitation of the Code Sec. 751(a) legislative history, the IRS left out the portion that indicated that the intent of the Code Sec. 751 was to "prevent the use of the partnership as a device for obtaining capital gain treatment on fees or other rights to income," and "to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests." There is no reference in this legislative history to the inventory rule of Code Sec. 453(b)(2)(B). Moreover, the change to Code Sec. 453(i), adding the reference to Code Sec. 751, pre-dates Rev. Rul. 89-108, and Code Sec. 453(i) is limited in its application to depreciation recapture. One certainly can argue that if Congress intended a similar rule to be applied to other Code Sec. 751 assets, such as inventory, it would have added such a provision when amending Code Sec. 453(i).

It is an entirely different ballgame with respect to a redemption of a membership interest. Code Sec. 736(a) provides that payments made in redemption of a partner's interest are considered (1) allocations of partnership income, if determined with regard to the income of the partnership (Code Sec. 736(a)(1)), or (2) guaranteed payments, if determined without regard to partnership income (Code Sec. 736(a)(2)), except to the extent the payments are for the partner's interest in partnership property (Code Sec. 736(b)). Payments for a partner's interest in partnership property are considered distributions. For this purpose, payments of a partner's share of the partnership's cash-basis receivables (as defined in Code Sec. 751(c)) are not considered to be in exchange for a partner's interest in partnership property.

Cash-basis receivables are among the items that fall into the penumbra of unrealized receivables under Code Sec. 751(c); however, depreciation recapture is not considered a Code Sec. 751(c) asset <u>for purposes of Code Sec. 736</u>. Consequently, if Toto's transaction is treated as a redemption of a partnership interest, the portion of the consideration attributable to his

$150,000 share of the cash-basis receivables would be taxed under the rules of Code Sec. 736(a), discussed below. On the other hand, Toto's $20,000 share of depreciation recapture would be taxed under the rules of Code Sec. 736(b), also as discussed below.

In the case of Toto's $20,000 share of the LLC's Code Sec. 1245 depreciation recapture, payments attributable to such items would be considered to be distributions and payments for Toto's interest in partnership property. Such also would be the case, if the LLC had held "substantially appreciated" inventory items (which it does not under the facts in this article). As such, the hot asset rules of Code Sec. 751(b) would raise their head. These rules provide that where a partner receives a distribution in exchange for his interest in substantially appreciated inventory items, the partnership is deemed to distribute such items to the partner and then re-purchase those items from the partner. In this manner, the partnership obtains its basis step-up (and would not need a Code Sec. 754 election for this purpose). Inventory items are substantially appreciated, if their value exceeds 120% of their adjusted basis to the partnership.

Note that a partnership's unrealized receivables are considered inventory items for purposes of determining whether a partnership's inventory items are substantially appreciated. Under this rule, the existence of accrual-basis accounts receivable lessens the amount of appreciation (because they generally have a basis that is substantially similar to or in excess of their value); whereas, the existence of depreciation recapture, which is considered an unrealized receivable, enhances the chance of inventory being substantially appreciated (because it is an asset having a basis of zero). Also note that there is no substantial appreciation test for inventory in the case of a sale or exchange of a membership interest. Consequently, in the case of a sale or exchange of a membership interest, an ordinary loss can occur, if the inventory has a basis in excess of its value.

As noted above, in the case of an installment sale or exchange of a membership interest, installment reporting is not available with respect to the transferor's share of the partnership's recapture items (Code Sec. 453(i)) or its inventory items (Rev. Rul. 89-108). However, a redemption is not treated as a sale or exchange transaction, rather it is treated as a distribution transaction. As such, it is not subject to the installment reporting rules of Code Sec. 453. Rather, it is subject to the rules of Code Sec. 736. Mechanically, Reg. §1.736-1(b)(5) provides that where payments are being made under Code Sec. 736, the recipient segregates each payment between what portion is considered to be a Code Sec. 736(b) payment, i.e., for the recipient's interest in partnership property, and which portion is considered to be a Code Sec. 736(a) payment, i.e., a distributive share of partnership income or a guaranteed payment.

Reg. §1.736-1(b)(5)(i) generally provides for a "default" pro rata allocation between Code Sec. 736(a) and Code Sec. 736(b) payments based on the relative amounts of each, as least insofar as the fixed portion of each payment, as reflected on Schedule 1. (There are special rules for allocation when the payments are not fixed in amount.) In lieu of the pro rata allocation, Reg. §1.736-1(b)(5)(iii) provides that "the allocation of each annual payment between section 736(a) and (b) may be made in any manner to which all the remaining partners and the withdrawing partner or his successor in interest agree, provided that the total amount allocated to property under Code Sec. 736(b) does not exceed the fair market value of such property at the date of death or retirement." Such an election could delay Toto's income recognition of the Code Sec. 736(a) payments; however, the quid pro quo is that Dorothy's and the Wizard's deduction is commensurately delayed. This election might be made where it is desired to structure Code Sec. 736(a) retirement payments in a manner to avoid SE tax under Code Sec. 1402(a)(10), as discussed above (i.e., all capital needs to have been returned for the Code Sec. 736(a) payments to be SE tax-free).

Lastly, it should be noted that the portion of the payments that are Code Sec. 736(b) payments is treated as a distribution and no gain is recognized until all basis is absorbed. However, Reg. §1.736-1(b)(6) provides that the recipient partner can elect (in his tax return for the first taxable year for which payments are received) to a pro rata use of basis (i.e., pro rata gain recognition). It is likely that a redeemed partner would not want to make this election, as it will result in the acceleration of income. However, the remaining partners generally would prefer the election because it will accelerate their Code Sec. 734(b) basis adjustment.

Timing of Basis Adjustments

In the case of a sale or exchange of a membership interest, Code Sec. 743(b) provides that the purchasing partners will have personal basis adjustments based on the difference between their respective shares of the seller's inside basis of the partnership's assets and the outside basis for the portion of their partnership interests purchased from the seller. Because Code Sec. 743 focuses on the difference between inside and outside basis (rather than the amount of gain recognized), this basis step-up takes place immediately, notwithstanding that the seller will recognize his capital gain over time. The timing of the basis adjustment in the case of a redemption of a partnership interest, which is controlled by Code Sec. 734(b), is completely different. Code Sec. 734(b) provides that the basis adjustments are made as gain is recognized by the distributee partner. (*See* Rev. Rul. 93-13, 1993-1 CB 126.) For example, under the facts in this article, this would mean that there would be a separate basis adjustment with respect to the portion of the gain recognition at closing allocable to the building and with respect to each $100,000 payment so allocable—i.e., six separate basis adjustments for the building.

For example, assume that in a redemption (1) Toto will receive ordinary income treatment with respect to his share of the intangible value of the LLC and (2) each payment will be allocated between Code Sec. 736(a) and Code Sec. 736(b) payments on a pro rata basis. In the case of a <u>sale or exchange</u> of Toto's membership interest, the entire $400,000 basis step-up in intangible value and the $630,000 basis step-up in the building would take place as of the date of the sale or exchange, and Dorothy and the Wizard would begin <u>immediate</u> depreciation and amortization of the basis step-up in the building and in the intangible value, respectively, immediate depreciation in the $20,000 basis adjustment for the FF&E, and would have a Code Sec. 743(b) basis adjustment to offset the income recognition from what was Toto's share of the cash-basis receivables. Toto, however, would have the following gain each year:

Year one gain—$700,000 ($500,000 cash payment plus $200,000 net relief of liabilities):	
Ordinary income for hot assets	$170,000*
Section 1250 capital gain	400,000
Residual capital gain on building	47,460
Capital gain on intangible value	82,540
	$700,000

Each of five $100,000 annual installments:	
Ordinary income for hot assets	$ 0
Residual capital gain on building	36,508
Capital gain on intangible value	63,492
	$100,000

* Assumes a position is not taken that installment reporting is available for the cash-basis accounts receivable. *See* discussion above.

On the other hand, in the case of a redemption of Toto's membership interest, the timing of the income recognition for Toto as between the various components of gain would be different, as would the timing of the basis adjustments for the LLC. Toto would have the income recognition each year as reflected on Schedule 1. The Code Sec. 734(b) basis adjustment would correlate with the timing of this income recognition, as reflected on Schedule 2.

Other Differences Between Sales or Exchanges and Redemptions

There are some other differences in the tax treatment between sale or exchanges and redemptions that sometimes need to be taken into account in planning an exit transaction, including:

1. While not relevant under the facts in this Article, Code Sec. 708(b)(1)(B) provides that a partnership is considered terminated, if there is a sale or exchange of 50% or more of the total interest in partnership capital and profits within a 12-month period. A partnership termination does not cause gain recognition for the remaining partners. In fact, in many respects it is business as usual—all assets and liabilities of the partnership are deemed contributed to a new partnership followed by the deemed distribution of partnership interests in the new partnership in termination of the old partnership. However, the new partnership must start depreciating the property all over again, using the prescribed methods and lives in effect as of the date of termination. In some circumstances, this distinction can cause significant timing differences. On the other hand, the redemption of a partnership interest is not treated as a sale or exchange under Code Sec. 708(b)(1)(B) (unless the redemption is recharacterized as a disguised sale of a partnership interest). Where termination is a concern, restructuring a sale or exchange as a redemption (if possible) can be quite advantageous. Or, perhaps, a partial redemption and a partial sale can be used, if there are other advantages of sale or exchange treatment that are desired (e.g., the more advantageous basis step-up rules in the case of an

installment purchase). For example, it is not uncommon in situations where there is to be a sale or exchange of the interest of a 50% partner to have the partnership redeem a .1% interest in order to avoid a Code Sec. 708(b)(1)(B) termination.

2. If Toto's transaction were structured as a sale or exchange of a membership interest, the imputed interest rules would apply to the $500,000 of deferred payments to reduce the purchase price and impute interest. On the other hand, in the case of an installment redemption, although there is no apparent specific authority, it is believed by most tax professionals that the imputed interest rules would not apply. The reason for this conclusion is that the redeemed member still is considered a partner for federal income tax purposes until the final payment for his LLC interest is made to him (Reg. §1.736-1(a)(1)(ii)) and not a creditor of the LLC, and, therefore, the deferred payment obligation is not a liability. *See* Reg. §1.736-1(b)(7) Ex. 1.

3. In the case of a partnership holding inventory items (which is not the case under the facts in this Article), such items are Code Sec. 751 hot assets regardless of value in the case of a sale or exchange of a membership interest; in the case of a redemption transaction, such items are hot assets only if substantially appreciated (i.e., a value that exceeds basis by more than 20%).

Conclusion

As discussed in this article, when a partner departs from a partnership and the exit strategy involves either a pro rata purchase by the remaining partners or a redemption by the partnership, there can be significant income tax differences between the choice of structures. The tax professional needs to be cognizant of these choices, so as to advise the selling partner or the "purchasers" properly.

SCHEDULE 1

ILLUSTRATION OF INSTALLMENT REDEMPTION

A redemption is treated as a distribution transaction. As such, it is not subject to the installment reporting rules of Code Sec. 453. Rather, it is subject to the rules of Code Sec. 736. Specifically, Reg. §1.736-1(b)(5) provides that each payment must be bifurcated between (1) Code Sec. 736(a) payments and (2) Code Sec. 736(b) payments for interests in partnership property. Such bifurcation is made on a pro rata basis, unless all the partners agree to a specific allocation to a particular asset (Reg. §1.736-1(b)(5)(iii)). Eventually, there will be $1,200,000 of income recognition ($200,000 negative capital account plus $1,000,000 cash consideration), which, under a pro rata approach, will be recognized as follows:

Year 1 consideration:

Cash	$ 500,000
Relief of liabilities	530,000
Total consideration	$1,030,000
Code Sec. 736(a) payments:	
Cash-basis receivables	$ 150,000
"Additional" retirement payments	400,000*
	$ 550,000
Code Sec. 736(b) payments:	
Cash	$ 33,333
FF&E ($20,000 of which is §1245 recapture**)	50,000
Building	896,667
	$ 980,000

Code Sec. 736(a) payment: $550,000/$1,530,000*** x 1,030,000 =	$ 370,261
§736(b) payment: $980,000/$1,530,000 x 1,030,000 =	659,739
Total payments	$1,030,000

*Assumes Code Sec. 736(b)(3) ordinary treatment is elected.
**Depreciation recapture, although normally an "unrealized receivable," is not so characterized for purposes of Code Sec.736.
***Represents total asset value.

The entire $370,261 of Code Sec. 736(a) payments would be treated as self-employment income. The $659,739 payment for Toto's interest in the Code Sec. 736(b) property would be considered a distribution transaction. There is a lack of clarity as to how this latter payment breaks down as between each asset, but presumably there would be a bifurcation of the FF&E basis and the FF&E recapture portion, with the following result:

	Total Amount Due	Relative %	Amount Received
Cash	$ 33,333	3.40%	$ 22,431
FF&E basis	30,000	3.06%	20,188
FF&E recapture	20,000	2.04%	13,459
Building	896,667	91.50%	603,661
	$980,000	100.00%	$659,739

The tax impact of the $659,739 Code Sec. 736(b) payment:

Ordinary income from FF&E recapture payment		$ 13,464
Remaining $646,280 payment ($659,739—$13,464)	$646,275	
Basis for membership interest	330,000*	
Capital gain		316,275
Total income recognition from Code Sec. 736(b) payment		$329,739
Total year one income recognition ($370,261 + $329,739)		$700,000

*Note total use of basis

Years 2-6 income recognition:

Code Sec. 736(a) payments: $550,000/$1,530,000 x 100,000 = 35,948 x 5 =	$ 179,739
Code Sec. 736(b) payments: $980,000/$1,530,000 x 100,000 = 64,052 x 5 =	320,261
	$ 500,000

Breakdown of Code Sec. 736(b) payments:

FF&E recapture:	$320,261 x 2.04% =	$ 6,536
Capital assets:	$320,261 x 97.96% =	313,725
		$320,261

Summary:

Total income recognition:		
Year 1: Code Sec. 736(a) payments	$370,261	
Years 2-6: Code Sec. 736(a) payments	179,739	
		$ 550,000
Year 1: Code Sec. 736(b) payments—hot assets	$ 13,464	
Years 2-6: Code Sec. 736(b) payments—hot assets	6,536	
		20,000
Total ordinary income recognition		570,000
Year 1: Code Sec. 736(b) payments—capital gain	$316,275	
Years 2-6: Code Sec. 736(b) payments—capital gain	313,725	
Total capital gain recognition		630,000
Total income recognition		$1,200,000

SCHEDULE 2

COMPARISON OF TIMING OF CODE SEC. 734(b) AND CODE SEC. 743(b) BASIS ADJUSTMENT

1. In the case of a sale or exchange of a partnership interest on an installment basis, the purchasing partners obtain their Code Sec. 743(b) adjustment immediately, regardless of when the selling partner recognizes gain. In other words, Dorothy and the Wizard collectively would have the following immediate basis adjustment:

Cash-basis receivables	$ 150,000
FF&E	20,000
Building	630,000
Intangible value	400,000
	$1,200,000

2. In the case of a redemption transaction, any Code Sec. 734(b) basis adjustment (and any deduction for Code Sec. 736(a) payments*) is only received as income is recognized by the distributee partner (with resulting multiple basis adjustments). Based on the structure of the Code Sec. 736 payments reflected on Schedule 1, the Code Sec. 734(b) basis adjustment/Code Sec. 736(a) deductions would occur in the following years:

	Year 1	Years 2-6	Total
Cash-basis receivables	$100,980	$ 49,020	$ 150,000
FF&E	13,464	6,536	20,000
Building	316,275	313,725	630,000
Intangible value	269,281	130,719	400,000
	$700,000	$500,000	$1,200,000

*Note that the $400,000 of intangible value is being amortized in the case of a sale or exchange, but deducted when paid in the case of a redemption where Code Sec. 736(b)(3) ordinary income treatment is elected.