

Tax Issues in Sale of Partnership & LLC Interests: Structuring the Purchase Agreement

Best Practices for Drafting and Negotiating Tax Provisions

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Tax Issues in Sale of Partnership & LLC Interests: Structuring the Purchase Agreement

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I. Introduction of Tax implications for buyer and seller

A. Tax Classification of Partnerships and LLCs

1. Eligible entities within meaning of 301.7701-3.
2. Mechanics to achieve certain goals differ depending upon classification of target.
3. Also consider pre-closing structure alternatives.

B. Seller's gain or loss

1. Sale of a partnership interest results in capital gain or loss, except for hot assets. Holding period generally determined by holding period of interest.
2. Character of gain/loss on sale of assets depends upon particular assets being sold; holding period determined by particular assets.
 - Remember sale of a disregarded LLC is a sale of assets.
3. Purchase price allocation important, and should be included in agreement.
4. Redemption of partnership interests:
 - 736(a) v. 736(b)
 - Differences between purchase across the top and redemption from the partnership
5. A partnership interest not eligible for 1031 like-kind exchange.
 - Disregarded entities?
 - Same partnership?

I. Introduction of Tax implications for buyer and seller (cont.)

• C. Buyer's basis

1. A buyer's basis is cost, including assumed liabilities.
2. Acquisition of assets results in basis in assets.
3. Acquisition of partnership interest results in basis in the interest itself; absent 754 election (or built-in loss situation), however, the step-up in basis in the partnership interest is not matched by a basis step-up in the assets held by the partnership.
4. Example: A owns a 40% interest in AB partnership with a value of \$4 and a basis of \$1. AB owns a single investment property ("X") with a value of \$10 and a basis of \$2.50.
 - C acquires A's interest for \$4. C's basis in 40% interest is \$4.
 - Without 754 election, AB's basis in X remains \$2.50. If X subsequently sold for \$10 (i.e. no post-C purchase appreciation), AB recognizes \$7.50 of gain, of which \$3 is allocated to C. C would receive an offsetting loss on liquidation, but timing issue.
 - With 754 election, AB's basis in X becomes \$5.50. On sale of X for \$10, C recognizes no further gain.

I. Introduction of Tax implications for buyer and seller (cont.)

- D. Installment reporting for selling partner

1. Gain on sale of a partnership interest generally eligible for installment reporting.
2. Impact of hot assets.
3. Better answer if structured as redemption?

- E. Income/Loss Allocation issues

1. Sections 706(c) and (d) are controlling provisions.
2. Each of buyer and seller must be allocated items for the year.
 - Pro ration
 - Close of the books (optional and mandatory)
3. Purchase agreement provisions.

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II. Structuring the Sale

- Assets Sales – Partnership level determination
 - Gain or loss depends on allocation of amount realized
 - Character determined with reference to each asset
 - Timing
 - Installment Sale
 - Depends on assets sold
 - Partner allocations – Section 704(b)

II. Structuring the Sale

- Assets Sales – Acquiring Company
 - Basis credit for assets based on Section 1012
 - Allocation of purchase price to assets affects cost recovery timing
 - Intangibles
 - 15 year recovery

II. Structuring the Sale (cont.)

B. Entity Sales

1. Defining the Transaction

- Sale of interest in a tax partnership v. sale of interest in disregarded entity
- Sale of 100% interests/units v. sale of less than 100%

2. Impact on purchase agreement (general)

- Income taxes v. non-income taxes
- Tax return preparation
- 706 allocation issues, including tax distributions.

3. Sell side concerns

- Capital gain v. ordinary income
- 751(a) exchange tables

4. Buyer concerns

- Basis step-up
- Input on tax-matters of underlying partnership going forward

5. Impact on purchase agreement (tax specific)

- Purchase price allocation
- Tax treatment
- Elections
- Post-closing risk allocation

6. Company concerns

- Impact on tax returns (termination?)
- Impact on method of account (sec. 448)

II. Structuring the Sale (cont.)

B. Entity Sales (cont.)

- Example:
 - A is a one-third partner in ABC LLC, a tax partnership.
 - A's interest has a basis of \$3.
 - ABC, a cash method partnership, has three fixed assets: (i) \$3 of cash; (ii) A/R with a value of \$9 and basis of \$0; and (iii) equipment with a value of \$9 and basis of \$6 (\$3 of depreciation previously claimed on equipment).
 - D wishes to purchase A's interest for \$9.
 - Assume purchase price allocated \$1 to cash, \$3 to a/r, \$3 to equipment, and remainder to goodwill.
- 1. Transaction:
 - A is selling an interest in a tax partnership representing less than 100% of the interests in the partnership.
- 2. To A:
 - As a sale of a partnership interest, sec. 741 provides for capital gain except to the extent of hot assets.
 - A's gain is \$6 (\$9-\$3). If ABC sold all of its assets, A would be allocated \$3 of income from A/R and \$1 of income from equipment, which would be recapture. Thus, \$4 of A's gain is ordinary. Remaining \$2 if capital.
- 3. To D:
 - \$9 of basis in acquired interest. No step-up in ABC assets without 754 election.
 - Will D simply step into shoes of A regarding tax matters?

II. Structuring the Sale (cont.)

B. Entity Sales (cont.)

- Example (cont.):
 1. Allocation issues: closing of the books under 706(c)
 2. Purchase agreement
 - How does D ensure 754 election if desired?
 - Purchase price allocation dictated A's ordinary income/cap gain mix.
 - Indemnity package—note impact on A's gain if indemnification obligation arises.
 3. Company issues
 - Sale of less than 50%--so no termination, but must now track.
 - Does D's admission cause change in method of accounting?

II. Structuring the Sale (cont.)

B. Entity Sales (cont.)

- Example Modified:

- Assume same facts, but instead of D buying directly from A, D contributes \$9 to ABC for a preferred interest (\$9 return of capital plus accruing return) and ABC uses \$9 to redeem A.

1. Transaction:

- Pursuant to 707(a)(2)(B), A still considered as selling an interest in a tax partnership representing less than 100% of the interests in the partnership.

2. To A:

- Same as above.

3. To D:

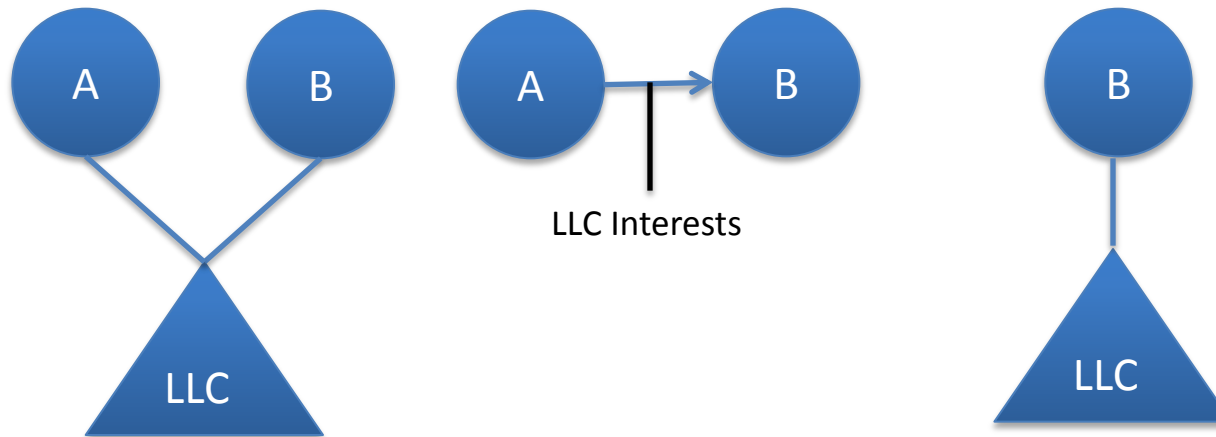
- Basis results the same as above \$9 of basis in acquired interest. No step-up in ABC assets without 754 election.
- Note, however, change in parties to transaction. D is contracting with ABC directly, and, due to nature of acquired interest, ABC operating agreement will need to be amended. Greater likelihood for control/access/754 election?

II. Structuring the Sale (cont.)

- Acquiring all Interests of LLC: Revenue Ruling 99-6

- Rev. Rul. 99-6
 - Gain or loss
 - Basis in assets
 - Holding period
 - Section 704(c) and 737
 - Terminate partnership

Rev. Rul. 99-6 – Situation 1



1. A and B each own 50% of LLC Interests
2. A sells all of its LLC Interest to B
3. B is the sole Member

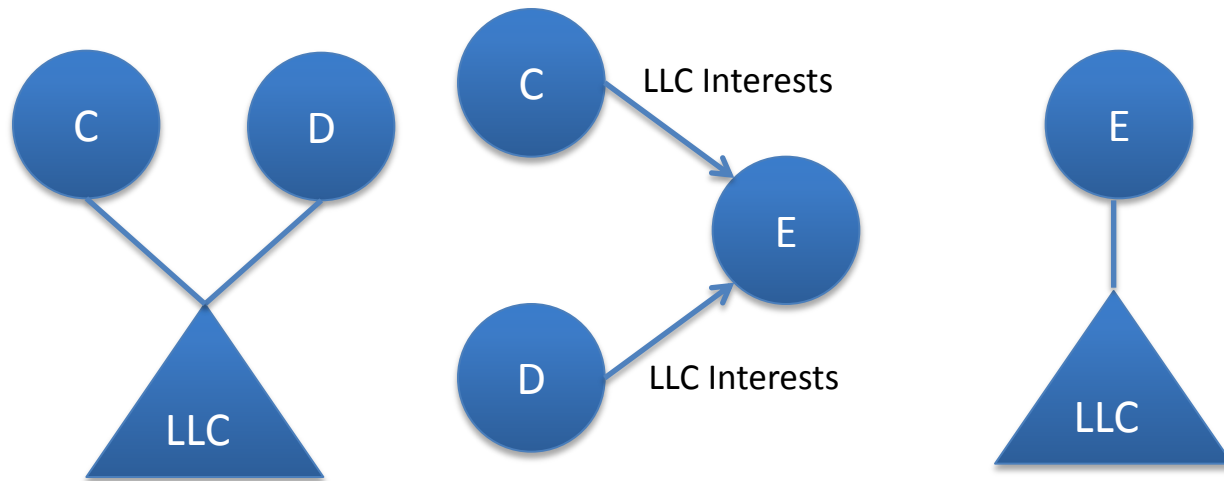
- Rev. Rul. 99-6 – Situation 1 – To A
 - Gain or loss
 - Section 741
 - Amount realized: includes 752 amounts
 - Section 751(a)
 - Changes character of gain in share of hot assets
 - » Includes depreciation recapture
 - » Not unrealized recapture gain

- Rev. Rul. 99-6 – Situation 1 – To B
 - Gain or loss
 - Section 731
 - Cash, marketable securities
 - 752 distributions
 - Section 1239 – sale of depreciable property between related parties
 - Section 735(a) – Sale or exchange of distributed unrealized receivables
 - Basis
 - Section 732(a)
 - B generally gets carryover basis in distributed property, to the extent of B’s basis in LLC interest
 - Section 1012
 - Property deemed acquired from A has a cost basis in B’s hands

- Rev. Rul. 99-6 – Situation 1 – To B
 - Holding Period
 - Section 735(b)
 - Tacking for capital assets and Section 1231 assets
 - No tacking for inventory, property held for sale in ordinary course
 - Section 704(c)(1)(A) and 737
 - Gain recognized on property distribution
 - B's contributed section 704(c) property deemed distributed to A
 - Exchange of other property for B's contributed Section 704(c) property

- Rev. Rul. 99-6 – Situation 1 – To B
 - Tax Partnership Terminates
 - Elections no longer effective
 - Depreciation periods start over

Rev. Rul. 99-6 – Situation 2



1. C and D each own 50% of LLC Interests
2. C and D sell all of their LLC Interest to E
3. E is the sole Member

- Rev. Rul. 99-6 – Situation 2 – To C and D
 - Gain or loss
 - Section 741
 - Amount realized: includes 752 amounts
 - Section 751(a)
 - Changes character of gain in share of hot assets
 - » Includes depreciation recapture
 - » Not unrealized recapture gain

- Rev. Rul. 99-6 – Situation 2 – To E
 - Basis
 - Section 1012
 - Cost of assets
 - Includes liabilities to which assets are subject
 - Holding Period
 - Date of “sale”

II. Structuring the Sale (cont.)

- Acquiring all Interests of LLC: Interests-Over Merger

- LLC Merger
 - Types
 - Gain or loss
 - Basis
 - Holding periods
 - Section 704(c)

- LLC Merger

- Types

- Interests-Over

- A and B transfer their AB LLC Interests to CD in exchange for CD LLC Interests
 - Treated as an “assets-over” merger

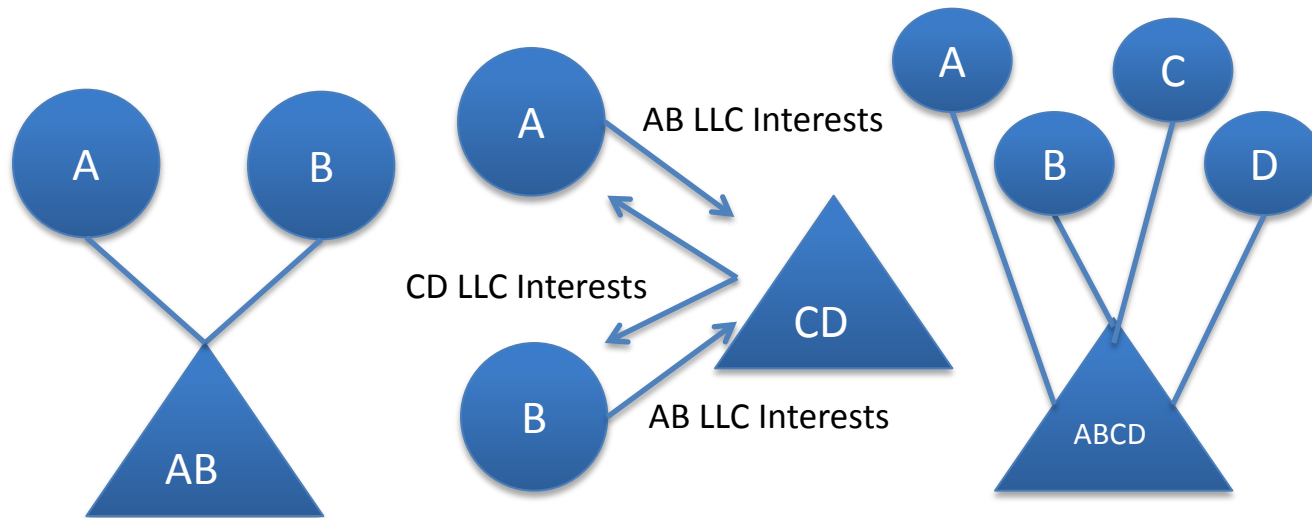
- Assets-Over

- AB LLC transfers its assets to CD LLC in exchange for CD LLC Interests, then distributes CD LLC Interests to A and B in liquidating distribution

- Assets-Up

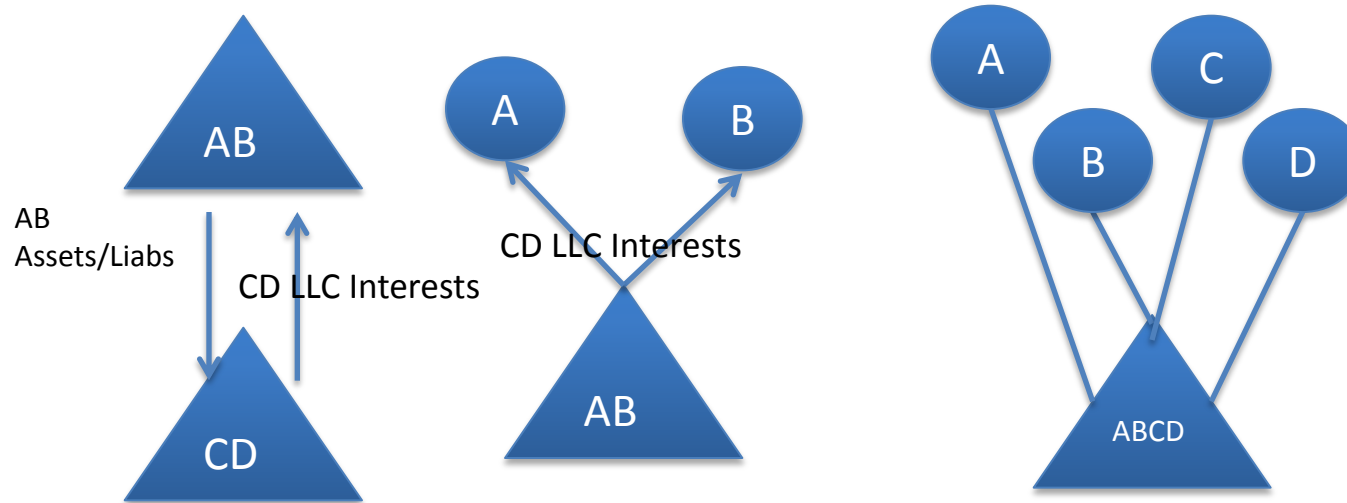
- AB liquidates; A and B contribute assets to CD LLC for CD LLC Interests

Interests Over Merger – State Law



-
1. A and B transfer AB LLC Interests to CD LLC for CD LLC Interests
 2. CD becomes ABCD LLC
 3. AB LLC terminated

Interests Over Merger – Tax Law



1. AB LLC transfers assets and liabilities to CD LLC for CD LLC Interests
2. AB LLC liquidates
3. AB LLC terminated

- Assets Over – for A and B
 - Gain
 - AB contributes assets and liabilities in 721 transaction
 - Possible gain from deemed distribution under 752 or actual distribution (if any)
 - A and B treated as receiving property in exchange for AB interests in liquidating transaction
 - Should be no gain or loss recognized under Section 731

- Assets Over – For A and B
 - Basis
 - A and B take basis in partnership interests under Section 732
 - Holding Period
 - LLC Interests are capital assets. Holding period tacking under Section 1223
 - Section 704(c)
 - New 7 year period begins with contribution to CD

II. Structuring the Sale (cont.)

• E. 99-5 Transactions

1. Defining the Transaction

- Where Target is an LLC that is wholly-owned, it is a disregarded entity for tax (absent CTB election).
- When less than 100% of the LLC units are acquired, the LLC becomes a tax partnership.

2. Units acquired from sole owner (asset sale)

3. Units acquired from LLC and proceeds remain with LLC (721)

4. Units acquired from LLC but proceeds distributed to sole owner (707(a)(2)(B))

- Example: A owns 100% of LLC, which has A/R (\$10) and goodwill (\$6). B contributes \$8 for a 50% interest. \$8 immediately distributed to A.
- B is treated as contributing cash to LLC solely for equity.
- A is treated as contributing A/R and goodwill to LLC in return for equity and cash. As a result, A deemed to sell \$8 of assets and will recognize income/gain.

II. Structuring the Sale (cont.)

• E. 99-5 Transactions (cont.)

1. S corporation is target

- Where S corporation is a target, but facet of transaction would preclude S corp treatment going forward, consider restructuring.
- S corp contributes assets to newly formed LLC, at which level transaction occurs.
- Rev. Rul. 2008-18 provides alternative if transfer of assets not feasible.

2. Example

- A owns 100% of Target, an S corp. B, a tax partnership, wishes to acquire a 50% stake in the business (or B is an individual but desires preferred equity).
- A contributes Target to New Holdco (which also qualifies as an S corp), and Target elects to be a Qsub. Target then converts into an LLC.
- B then invests directly into LLC. 99-5 principles apply to investment.

3. Sec. 197 planning

- If B wishes to amortize Target's goodwill but Target subject to anti-churning, further planning is required. Compare 1.197-2(k) examples 18 and 19.
- In example above, following LLC drop down, A invests in LLC to make LLC a tax partnership. Timing?

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cutting through complexity

Allocation of Purchase Price in Asset Sale

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III. Allocation Of Purchase Price In An Asset Sale

Character – Asset Sale

- **Gain or loss from the sale of assets**
 - Difference between the amount realized and the adjusted basis of the property sold. Section 1001(a).
- **Character**
 - Capital gain or loss from sale of capital assets
 - Ordinary income or loss from noncapital assets
 - Net gain taxed as capital gain and net loss treated as ordinary loss from the sale of section 1231 assets
- **Gain or loss allocated under the partnership agreement**
 - If the partnership sells assets the gain or loss is recognized by the partnership.
 - Allocation of gain or loss by partnership must satisfy section 704(b).

Character – Asset Sale – Valuation of Assets

- **Section 1060**

- Provides rules for determining transferee's basis and transferor's gain or loss when there is an applicable asset acquisition.
- Applicable asset acquisition is any transfer –
 - Of assets constituting a trade or business,
 - Where the transferee's basis is determined wholly by reference to the consideration paid for such assets.
- Consideration must be allocated among the assets in the same manner as under section 338(b)(5).

- **Allocation of consideration**

- Allocated under the residual method under regulations 1.338-6 and 1.338-7.
- Seven classes of assets used in the residual method.

- **When should section 1060 type considerations be applied to valuing assets?**

Sale of Partnership Interest – Character – Section 751(a)

- **Section 741** – Generally considered gain or loss from the sale of a capital asset.
- **Section 751(a) (exception)** – The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his/her interest in the partnership attributable to *unrealized receivables* or *inventory items* of the partnership shall be considered as an amount realized from the sale or exchange of property other than a capital asset.
 - For sales and exchanges of interests, “inventory” includes all inventory items, not only “substantially appreciated” inventory items as in the case of disproportionate distributions subject to section 751(b)
 - Unrealized receivables and inventory items, as described in section 751, are also known as “hot assets”

Character – Section 751(a)

Amount subject to section 751(a)

Net amount of income or loss from section 751 property that would have been allocated to the transferor partner (to the extent attributable to the interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the FMV of such property (section 1.751-1(a)(2)).

Amount subject to section 751(a) is ordinary income or loss and the remaining amount of “gain or loss” is capital

Preliminary Capital Gain or Loss
Less Section 751(a) Ordinary Income or Loss
Equals Actual Capital Gain or Loss

Applicable Capital Gains Rate

- **Aggregate theory applies to sale of partnership interest.**
 - Look through partnership to underlying assets.
- **Maximum rates for LTCG:**
 - 28% rate for collectibles gain.
 - 25% rate for unrecaptured sec. 1250 gain.
 - 20% rate for balance.

Applicable Capital Gains Rate

- **Partnership collectibles and section 1250 property:**
 - Selling partner recognizes gain as if the partnership sold all of its collectibles and section 1250 property in a fully taxable transaction immediately before he sold his interest.
 - Does not apply to redemptions.
 - Look through rule for tiered partnerships.

Applicable Capital Gains Rate

	Amount realized
<i>Less</i>	<u>(Adjusted basis)</u>
=	Total gain or loss
<i>Less</i>	(Ordinary income (section 751(a)))
<i>Less</i>	<u>(STCG or STCL)</u>
=	“Pre-Look-Thru” LTCG or LTCL
<i>Less</i>	(Collectibles gain)
<i>Less</i>	<u>(Unrecaptured section 1250 gain)</u>
=	Residual LTCG or LTCL

Summary Example

- **A and B are equal partners in a partnership with each having contributed cash to the partnership in formation.**
- **After holding his interest for more than one year, A sells his entire interest in the partnership to C for \$10,000.**
- **The partnership has the following balance sheet:**

Summary Example

<u>Assets</u>	<u>Tax Basis</u>	<u>FMV</u>	<u>A's Share of Gain (Loss)</u>
Collectibles	1,000	2,000	500
Unrealized receivables	0	14,000	7,000
Section 1250 property *(original cost > 1,000)	0	1,000	500
Other capital assets	<u>6,000</u>	<u>3,000</u>	<u>(1,500)</u>
Total Assets	7,000	20,000	6,500
Capital: A	3,500	10,000	6,500
Capital: B	<u>3,500</u>	<u>10,000</u>	
Total Liabilities/Capital	7,000	20,000	6,500

Summary Example

Amount realized	10,000	
<u>(Adjusted basis)</u>	<u>(3,500)</u>	
Total gain or loss	6,500	
(Ordinary income (section 751(a)))	(7,000)	7,000
<u>(STCG or STCL)</u>	<u>(0)</u>	
“Pre-Look-Thru” LTCL or (LTCL)	(500)	
(Collectibles gain)	(500)	500
<u>(Unrecaptured section 1250 gain)</u>	<u>(500)</u>	500
Residual LTCL or (LTCL)	(1,500)	<u>(1,500)</u>
		<u>6,500</u>

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Section 751(a) – Reporting Requirements

- **A partnership must file Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests***
 - Generally attach to Form 1065 unless the partnership receives notice of transfer subsequent to the filing of Form 1065
- **The transferor partner in a partnership holding section 751 property must attach a statement to its tax return reporting –**
 - The date of the sale or exchange;
 - The amount of gain or loss attributable to section 751 property; and
 - The amount of any gain or loss attributable to capital gain or loss

Impact on Selling Partner – Recap

- **Amount of gain or loss**
 - Liabilities relieved included in amount realized
 - Adjusted tax basis includes seller's distributive share of income or loss through the date of sale
 - Section 706
- **Character of gain or loss:**
 - Capital, unless section 751 applies.
- **Holding period may be bifurcated:**
 - Part short-term / Part long-term.
- **Different capital gains rates may apply.**

Impact on Buying Partner

- **Basis in acquired interest equals:**
 - Cost (cash + FMV of property);
 - *Plus* share of liabilities assumed.
- **Consider basis adjustments.**
- **Termination of the partnership.**
 - Actual termination: Buying partner owns 100% of partnership. Section 708(b)(1)(A).
 - Technical termination: 50% or more of the capital and profits interests are transferred within a 12-month period. Section 708(b)(1)(B).
- **Impact on partnership's tax year?**

Purpose of Section 743(b) Adjustments

- **Protects purchasing partner from gain or loss inherent in the partnership interest.**
- **Treats partner as if he purchased an interest in each partnership asset.**
- **Affects transferee partner only.**

Effect of Section 743(b) Adjustments

- **Sale of adjusted property:**

- Sec. 743(b) adjustment does not affect gain recognized by the partnership on sale of its assets.
- Adjustment affects gain recognized by the transferee partner only.

- **Three basic steps:**

1. Compute partnership's gain or loss from sale of property.
2. Allocate gain or loss to the partners under sec. 704(b) and 704(c).
3. Adjust transferee partner's share of gain or loss for sec. 743(b) adjustments on the property.

Effect of Section 743(b) Adjustments

- **Adjustments to depreciable property:**
 - Positive Adjustments:
 - Treated as a newly placed in service asset.
 - Creates additional depreciation for the transferee partner.
 - Special rule for remedial allocation method.
 - Negative Adjustments:
 - Recovered over remaining useful life of property.
 - Reduces the transferee partner's depreciation allocation.
 - May trigger ordinary income.

Reporting Requirements

- **The transferee partner that acquires interest in PRS that has section 754 election in effect must notify PRS of transfer within 30 days.**
 1. Include names, addresses, and tax identification number of transferee and transferor (if known)
 2. Date of transfer
 3. Relationship, if any, of transferee and transferor
 4. Other information necessary so that the partnership can calculate transferee's basis in its acquired interest (e.g., purchase price and liabilities assumed)
- **PRS must include statement with return for taxable year that it acquires knowledge of transfer.**
 - Identify transferee, show basis adjustment, and the allocation of the adjustment.

Impact on Buying Partner – Recap

- **Basis in the partnership interest acquired**
 - Cost basis (assuming taxable purchase)
 - Share of partnership debt
- **Section 754 election**
 - Already in effect or should the partnership make one?
 - Mandatory adjustment?
- **Section 706 method**
- **Section 704(c)**
 - Step-in-the-shoes
 - Section 704(c)(1)(C) exception