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Navigating the Tax Rules Pertaining to Sale/Transfer of Limited Liability Company Interests, Partnership Interests or Assets

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OVERVIEW

- **Main Objective** – To identify legal Issues to be addressed with your clients and the tax issues to address with your client's tax advisor.
- **Practitioner Questions** – Designated throughout the materials – key questions to ask and to focus on with clients.
- **Primary Focus** – Identifying key tax areas that can affect how you assist your client in negotiating and drafting a transaction.
- **Know enough to ask the question and then know where to go to get the answer!**

SALE OF PARTNERSHIP INTERESTS

- **Recognizing Gain or Loss – SELLER'S ISSUE:**
  - Ordinary Income – unrealized receivables (sale of goods or services) and substantially appreciated inventory (assets held in stock or trade for sale to its customers) (IRC 751)
  - Capital Gain or Loss – all other partnership property (IRC 741)
- **Practitioner Questions:**
  - Accrual Method or Cash Method Accounting – if accrual already reported as ordinary income at time of accrual and not planning issue.
  - Identify Types of Assets Involved in Sale – identify receivables and inventory and how this will affect the transaction.

SALE OF PARTNERSHIP INTERESTS

(continued)

- **BASIS – PURCHASER'S ISSUE:**
  - Outside Basis – Purchaser's Basis in partnership interest unrelated to partnership's basis in assets.
    - Assumption of liabilities will impact and increase – be aware if part of assets being purchased is an assumption of liabilities.
  - Inside Basis – Partnership's basis in the assets owned by the partnership.
- **Practitioner Questions:**
  - From a practitioner's perspective, be aware of the difference in basis and let the accountant determine the value of each.
  - Becomes important when you explore with your client the "exit" strategy for the business, when, how and to whom they anticipate selling to eventually, if at all, etc.

SALE OF PARTNERSHIP INTERESTS

(continued)

- ADDING A PARTNER – BASIS ISSUES:
  - Section 754 Basis Adjustment – the discrepancy may arise when a portion of the partnership is sold to a new incoming partner – the cost likely is equivalent to the fair market value.
  - This adjustment would allow the partnership to adjust the basis of each of its assets to reflect the fair market value paid by the income partner and help alleviate or reduce taxable gains or losses upon the sale of the assets.
- Practitioner Questions:
  - From a practical perspective, again, be aware of the goals of your client in purchasing the assets as the basis and adjustment made to the same at the beginning of the transaction will affect the end result.

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PARTNERSHIP TERMINATION

- FACTORS THAT CAN TRIGGER PARTNERSHIP TERMINATION – Be Aware!
  - Unintended consequences could result due to the structure of the sale of assets or partnership interest. (IRC 708)
  - A partnership is considered "terminated" for tax purposes if:
    - 1. No part of any business, financial operation or venture continues to be carried on by any of its partners.
    - 2. Sale or Exchange of 50% or more of the total interest in capital and profits of the partnership within a 12 month period.
- Practitioner Questions:
  - Be aware that the structure of the transaction you outline for your client may have unintended consequences.

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REPORTING

- FORM 8308
  - This form must be filed upon the sale or exchange of partnership interests where Section 751 property is involved.
  - Must be filed in the tax year in which the sale took place.
- Practitioner Questions:
  - Notify accountant of the sale.

TAX AUDIT GUIDE

- IRS Partnership Audit Technique Guide – Chapter 7 – Dispositions of Partnership Interests

- Practitioner Questions:
  - As a general rule, it is good to look at how the rules are applied by the taxing authority and this Guide is a great summary of the issues involved in the sale of a partnership interest and allows the lawyer to properly plan and negotiate around potential negative scenarios.

STRUCTURE OF THE SALE
ASSETS V. ENTITY

- How to structure the sale – asset sale v. entity sale?
  - Asset Sale – stepped up basis or purchased assets.
  - Entity Sale – basis equivalent to the amount paid for the units plus the acquisition costs.
- Practitioner Questions:
  - This is typically a Purchaser-driven issue.
  - Other factors may come into play such as assumption of liabilities if purchasing or acquiring an ongoing business operation versus just purchasing the assets.
  - Transaction Checklist - p. 9 of Materials.

NEGOTIATION OF ALLOCATION OF PURCHASE PRICE – ASSET SALE

- When a transaction is structured as an asset sale, one of the primary issues that is negotiated is the allocation of the purchase price.
  - Seller Perspective – capital gain/loss determined by characterization of asset and amount of value attributed to each.
  - Buyer Perspective – the allocation is important as the cost basis is determined by allocation to each asset.
- Practitioner Questions:
  - Make checklist of assets with client and discuss allocation with accountant.
  - Characterize (see checklist).

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SUMMARY CHECKLIST OF TAX IMPLICATIONS PERTAINING TO ASSET ALLOCATION.

- Membership Units:
  - Seller: Capital gains tax rate for stock held more than one year
  - Buyer: No write off; must accept assets at current book value (i.e., existing depreciation schedule)
- Covenant Not to Compete
  - Seller: Ordinary income to recipient (is considered personal to seller / principal)
  - Buyer: Amortize value over 15 years
- Training / Consulting Agreement:
  - Seller – Ordinary income
  - Buyer- Expense out as paid

SUMMARY CHECKLIST OF TAX IMPLICATIONS PERTAINING TO ASSET ALLOCATION (con't)

- Tangible Personal Property (trade fixtures, furniture, equipment)
  - Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
  - Buyer: Established basis, depreciate per IRS schedules
- Premise Lease (if the lease is at below market rent, it is an intangible asset):
  - Seller: If held for more than one year, is long-term capital gain
  - Buyer: Amortize value over 15 years

SUMMARY CHECKLIST OF TAX IMPLICATIONS PERTAINING TO ASSET ALLOCATION (con't)

- **Registered Vehicles** (do not include in Tangible Personal Property above):
  - Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
  - Buyer: Established basis, depreciate per IRS schedules
- **Liquor License** (include license type and number; is an intangible asset):
  - Seller: If held for more than one year, is long-term capital gain
  - Buyer: Amortize over 15 years
- **Customer List:**
  - Seller: Ordinary income as received
  - Buyer: Amortize over 15 years

SUMMARY CHECKLIST OF TAX IMPLICATIONS PERTAINING TO ASSET ALLOCATION (con't)

- Goodwill:
  - Seller: If held for more than one year, is long-term capital gain
  - Buyer: Amortize over 15 years
- Buildings:
  - Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain; otherwise ordinary income
  - Buyer: Establishes basis, depreciate per IRS schedules

SUMMARY CHECKLIST OF TAX IMPLICATIONS PERTAINING TO ASSET ALLOCATION (con't)

- Land:
  - Seller: If held more than one year, the gains in excess of depreciation are long-term capital gain, otherwise ordinary income
  - Buyer: No immediate tax impacts
- Inventory:
  - Seller: Ordinary income, to the extent that is over basis
  - Buyer: Treated as "cost of goods sold" upon sale of products

REPORTING OF ASSET SALE

- Form 8594 (IRC 1060)
  - See Exhibit C.
  - Required to be filed by both Buyer and Seller.
- Practitioner Questions:
  - Work closely with client's tax advisor and make sure purchase agreement sets forth both parties' agreement to comply and cooperate in the same.

HOW TO STRUCTURE PAYMENT TERMS NOW OR LATER?

- There are many ways to structure payment to a Seller.
  - Carry Back Loan to Seller.
  - Installment Purchase.
  - Balloon Payment.
  - Covenant Not to Compete.
  - Employment Agreements.
  - Consulting Agreements.
- Practitioner Questions:
  - Take into consideration all delayed payment options and discuss fully with client.
  - Careful of cross-default issues.