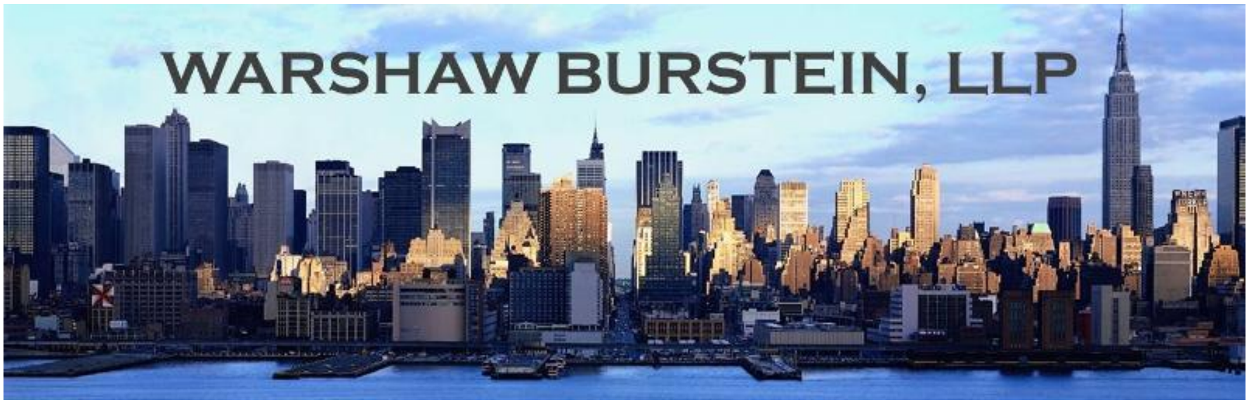

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CLIENT ALERT

TAX ASPECTS OF PURCHASES AND SALES OF PARTNERSHIP INTERESTS: THE BASICS

Many investors who are considering the purchase or sale of ownership interests in partnerships or limited liability companies are unacquainted with some of the more significant federal income tax aspects of those transactions. We hope the following discussion will give the reader a basic understanding of the economic burdens and benefits to be generated by such transactions and their allocation among the parties to the transaction.

The Aggregate and Entity Concepts

The provisions of the Internal Revenue Code dealing with the taxation of partners and partnerships represent two views as to the nature of a partnership. The first view, sometimes referred to as the “aggregate” view of partnerships, is that a partnership is simply an aggregate of individuals, each of whom should be treated as the owner of a direct undivided interest in partnership assets and operations. The second view, sometimes referred to as the “entity” view is that a partnership is a separate entity, with a tax existence apart from its partners. Under this view, a partner has no direct interest in partnership assets or operations, but only an interest in the partnership entity. The aggregate view predominates in connection with the taxation of partnership income to the partners. The entity approach, on the other hand, predominates in the treatment of transfers of partnership interests. However, aggregate notions also come into play in in the treatment of transfers of partnership interests, particularly in connection with the tax treatment of a seller of an interest in a partnership that owns “hot assets” (as described below) and of a purchaser of a partnership interest who pay a purchase price that is greater or less than his or her proportionate share of the basis of the partnership’s assets. The effect of these aggregate notions will be discussed more fully below.

Running throughout the statutory scheme governing the taxation of partners and partnerships is the notion that a partner has a basis in his or her partnership interest that is separate and distinct from the basis that the partnership has in its assets. A partner's basis in his or her interest is sometimes referred to as his or her "outside" basis, and a partnership's basis in its assets is sometimes referred to as its "inside" basis.

Treatment of Seller

If the entity view were strictly applied, the tax treatment of the seller of an interest in a partnership would strongly resemble the tax treatment of the seller of corporate shares, that is, gain or loss on the sale would be treated as residual capital gain or loss regardless of the nature of the assets held by the partnership or the nature of its operations. There are three major exceptions to the aggregate view underlying the general rules governing the tax treatment of a partner who sells all or a portion of a partnership interest.

(a) The General Rule

Any gain or loss realized by a partner upon a sale of all or a portion of a partnership interest is generally recognized and treated as a sale or exchange of a "residual" capital asset (that is, a capital asset that is neither a "collectible" nor a real estate asset that would generate unrecaptured Section 1250 gain). The gain or loss realized by the partner is equal to the difference between the amount realized on the sale and the outside basis of the partnership interest at the time of sale.

The amount realized on the sale consists of the sum of any money and the fair market value of any property received by the seller of the partnership interest, plus his or her allocable share of partnership liabilities. A partner's outside basis at the time of sale is generally the sum of the amount of money and his or her basis in any property contributed to the partnership in exchange for the partnership interest (or in the case of an interest acquired other than by contribution, the amount of money and the fair market value of any property the partner paid to acquire the interest), (i) *increased* by his or her allocable share of partnership income (taxable and tax-exempt) for prior years and for the portion of the current year ending with the sale and his or her allocable share of partnership liabilities and (ii) *decreased* by his or her allocable share of partnership losses and nondeductible, noncapital partnership expenditures for prior years and for the portion of the current year ending on the date of the sale and the amount of money and the partner's basis in any property distributed to him or her by the partnership. If the seller is both a general partner and a limited partner, the computation of the outside basis is complicated in the event the partner sells all or a portion of one interest while retaining the other. (In computing the amount of gain or loss a partner realizes on the sale of a partnership interest, the amount of such gain or loss is generally equal to the difference between the amount realized [determined without taking his or her allocable share of partnership liabilities into account] and the basis of the partnership interest [as so determined].)

A partner's holding period for a partnership interest acquired other than by contribution is determined by reference to the period of time the partner held the interest. A partner's holding period for a partnership interest acquired by contribution may be determined by reference to both the holding period of assets contributed by the partner to the partnership and the period of time the partner held the interest. A partner who contributes to a partnership noncapital property or property that is not "Section 1231(b) property" (i.e., depreciable personal property or real property that was used in a trade or business and held for more than one year) has a fresh holding period in the partnership interest received in exchange for the contribution. A partner who contributes to a partnership capital property or Section 1231(b) property is entitled to tack the holding period of the contributed assets to the holding period for the partnership interest received in exchange for the contribution. A partner who contributes capital property and/or Section 1231(b) property and other types of property or money to the partnership is required to fragment his or her holding period in accordance with the fair market values of the contributed assets. A partner who acquires partnership interests at different times is also required to fragment his or her holding period.

(a) <u>Exceptions</u>

There are three major exceptions to the entity view underlying the general rules governing the tax treatment of a partner who sells all or a portion of a partnership interest.

The Collapsible Partnership Exception. One major exception applies to the sale of an interest in a "collapsible" partnership. A "collapsible" partnership is a partnership that holds "hot assets" (that is, assets that would generate ordinary income if sold by the partnership, such as inventory, other noncapital, non-Section 1231(b) assets, assets subject to depreciation recapture and, in the case of a cash basis partnership, accounts receivable). A partner will recognize ordinary income or loss on the sale of an interest in a collapsible partnership equal to his or her allocable share of the partnership income or loss that would have been generated by a sale of all of the partnership's hot assets for cash in an amount equal to their fair market value and will recognize capital gain or loss on the sale measured by the difference between the amount of capital gain or loss he or she would have recognized on the sale if the special rule regarding hot assets had not applied and the amount of ordinary income or loss he or she recognized as a result of the hypothetical sale of hot assets.

Any premium received by the selling partner (that is, any amount received in excess of the share of the inside basis allocable to the partnership interest) will generally be capital gain and any discount (that is, the amount by which the share of the inside basis allocable to the partnership interest exceeds any amount received) will generally reduce capital gain (or create or increase capital loss) from the sale. Sales of interests in a collapsible partnership can generate both ordinary income and capital loss (or vice versa). A seller can recognize ordinary income on a sale of an interest in a collapsible partnership despite realizing a net loss on the transaction as a whole.

Internal Revenue Service Regulations give no credence to attempts by the parties to allocate the purchase price of hot assets. Nevertheless, such allocations continue to be good practice because they minimize the likelihood of disputes arising with the Internal Revenue Service as a result of the parties taking inconsistent positions. From the seller's perspective, an optimum allocation agreement would allocate to each hot asset a portion of the purchase price for his or her interest equal to the basis of that hot asset.

IRS Regulations require the seller of an interest in a partnership that holds hot assets to file a statement with his or her tax return for the year of the sale setting forth the date of the sale, the amount of gain or loss attributable to hot assets and the amount of capital gain or loss.

Capital Gain Look-Thru Exception. A second major exception applies where the partnership holds collectibles or real estate assets that would generate unrecaptured Section 1250 gain if sold by the partnership. A partner who sells an interest in a partnership that holds such assets will recognize collectibles gain and unrecaptured Section 1250 gain equal to his or her allocable share of the partnership collectibles gain and unrecaptured Section 1250 gain that would have been generated by a sale of all of the partnership's real estate assets and collectibles for cash in an amount equal to their fair market value. If the sum of the collectibles gain and unrecaptured Section 1250 gain recognized by the partner exceeds the amount of gain recognized by the partner on the transaction as a whole, the excess will be recognized as a residual capital loss.

Passive Income Look-Thru Exception. A third major exception applies to a partner who sells all or a portion of an interest in a partnership that holds property that, if sold by the partnership would generate gain required to be taken into account in determining his or her liability for the 3.8 percent Medicare contribution tax on net investment income. "Net investment income" includes any net gain attributable to dispositions of property, except property held in a nonpassive trade or business (other than a trade or business of trading in financial instruments or commodities). A partner who sells an interest in a partnership that holds such property will recognize net gain to the extent of the net gain that he or she would have been taken into account if the partnership had sold all of its assets for fair market value immediately before the sale.

Treatment of Purchaser

If the entity view were strictly applied, the tax treatment of the purchaser of an interest in a partnership would strongly resemble the tax treatment of the purchaser of corporate shares, that is, the basis of partnership property would attach solely to his or her partnership interest regardless of whether he or she paid a premium or received a discount. As noted above, while the entity approach predominates in the treatment of transfers of partnership interests, the aggregate view comes into play in connection with the tax treatment of purchasers of partnership interests who pay a price that is greater or less than the seller's allocable share of the inside basis.

The entity approach is codified in the general rule that the basis of partnership property is not adjusted as a result of a sale of a partnership interest. However, if the partnership elects to be subject to the optional basis rules described below or the partnership has a substantial built-in loss immediately after the sale, the entity rule gives way to the aggregate approach.

(a) <u>The Optional Basis Adjustment</u>

If a partnership election to be subject to the optional basis rules is in effect for the year in which a partnership interest is sold (commonly referred to as a Section 754 election), the basis of the partnership's assets is adjusted *only with respect to the purchaser.* The amount of the adjustment is equal to difference between the purchaser's initial basis in the partnership interest and his proportionate share of the inside basis. If the purchaser's basis in his partnership interest is greater than his share of the inside basis, the adjustment increases the inside basis with respect to the purchaser; if it is less, the adjustment decreases the inside basis with respect to the purchaser. Overall, the purchaser's share of the inside basis is the same as it would have been if the purchaser had acquired a direct interest in the partnership's assets. If the adjustment increases the inside basis, the purchaser is likely (i) to increase the amount of depreciation he or she is allowed in respect of partnership assets, without decreasing the amount of depreciation the continuing partners are allowed in respect of those assets, and (ii) to decrease the amount of gain (or increase the amount of loss) he or she recognizes when a partnership asset is sold, without increasing the amount of gain (or decreasing the amount of loss) the continuing partners recognize in the sale.

(b) <u>The Built-In Loss Exception</u>

If a Section 754 election is not in effect for the year in which a partnership interest is sold then (i) if the partnership has a substantial built-in loss immediately after the sale of a partnership interest (i.e., if the inside basis then exceeds the gross fair market value of the partnership's assets by more than $25,000), the basis of the partnership's assets must be adjusted as if such an election were in effect; and (ii) when partnership property is distributed to the purchaser within two years of the purchase, the basis of the distributed asset *may*, at the option of the purchaser, be determined as if such an election had been in effect and *must* be so determined, regardless of when the distribution occurs, if the market value of partnership property at the time of the sale exceeded 110 percent of the inside basis at the time and certain other conditions are met.

If a partnership interest is acquired in a taxable exchange, the purchaser's initial basis in his or her partnership interest is his or her cost, inclusive of the purchaser's allocable share of the partnership's liabilities.

Interest expense incurred by the purchaser on debt used to acquire the partnership interest is allocated to the assets of the partnership using any reasonable method. The interest expense takes on the character of the asset to which it is allocated, and is active or passive depending on the purchaser's relationship to the activity in which the asset is used by the partnership.

Treatment of Continuing Partners

Continuing partners in the partnership are not affected by the transfer of a partnership interest unless the transfer causes a "termination" of the partnership for federal income tax purposes. Generally, a transfer does not terminate a partnership unless 50 percent or more of the total interest in partnership capital and profits is sold or exchanged within a twelve-month period. The only significant consequence of termination is that the partnership generally will be required to depreciate its assets as if they were acquired on the date of termination under the same depreciation system it was using prior to termination.

The foregoing discussion touches on the issues most frequently encountered when a partnership interest is sold, It does not address the frequently contentious issue of how a basis adjustment resulting from the difference between a purchaser's initial basis in a partnership interest and his or her proportionate share of the inside basis is to be allocated among the partnership's assets. Nor does it address a number of other important collateral issues, including how a partner's allocable share of partnership liabilities is to be determined, or how a purchaser's proportionate share of inside basis is to be determined, or a number of special situations, including acquisitions that leave the purchaser as the sole owner of the partnership, installment sales of partnership interests, bargain sales of partnership interests and sales of interests holding installment notes.

Tax consequences weigh heavily in structuring a transaction involving the purchase or sale of partnership interests. Prior to entering into a transaction of this kind, you should carefully review tax considerations. Please contact the undersigned or your regular Warshaw Burstein attorney with any questions you have.

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