

2011

Real Estate Partnership And LLC Divorces

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REAL ESTATE PARTNERSHIP AND LLC DIVORCES

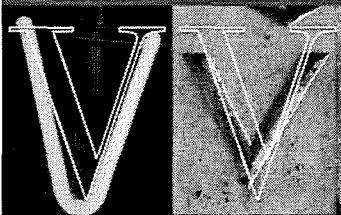
Breaking Up Is Not Always So Hard To Do

57th Annual William & Mary Tax Conference

Cameron N. Cosby

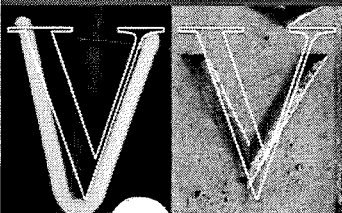
Brian J. O'Connor

November 10, 2011



CASE STUDY

A and B, unrelated individual taxpayers, have been 50-50 members in Real Estate LLC 1 and Real Estate LLC 2 for many years. Both LLCs are treated as partnerships for tax purposes. Although A and B have seen many good economic times together, their relationship recently has become strained. As a result, both members have decided to permanently part ways. Both A and B have large negative capital accounts in both LLCs.



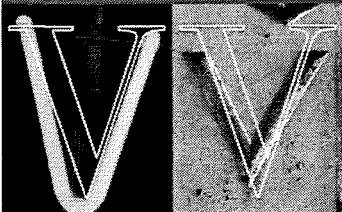
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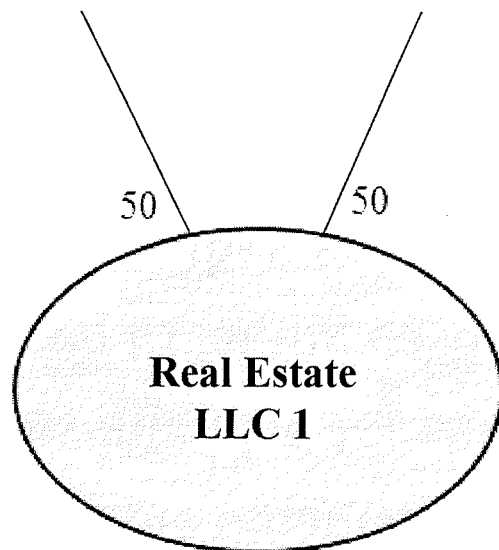
CASE STUDY (cont.)

Real Estate LLC 1 holds an office building leased to multiple tenants, and Real Estate LLC 2 holds real estate lots intended for sale to customers. Both A and B are open to taking cash upon a separation of the LLCs as long as they can avoid recognizing a significant taxable gain. Otherwise, A would accept a 100% interest in the office building, and B would accept a 100% interest in the lots. As a final alternative, the members would be willing to accept other real estate of their choosing outside the LLCs in exchange for their LLC interests.



CASE STUDY (cont.)

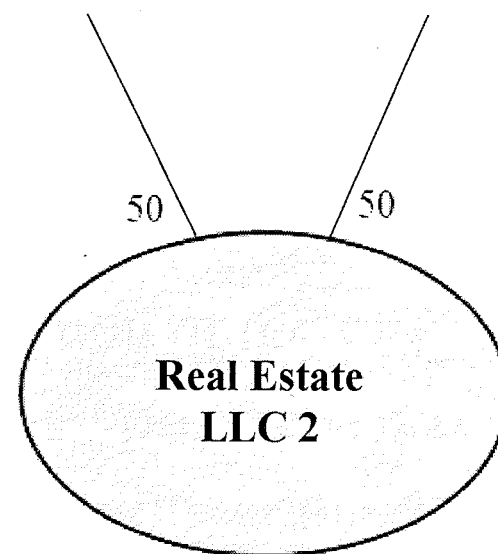
<u>A</u>		<u>B</u>	
Liabilities	500	Liabilities	500
Tax Basis	100	Tax Basis	100
Capital	(400)	Capital	(400)



Office Building

* No
inside/outside
basis differences

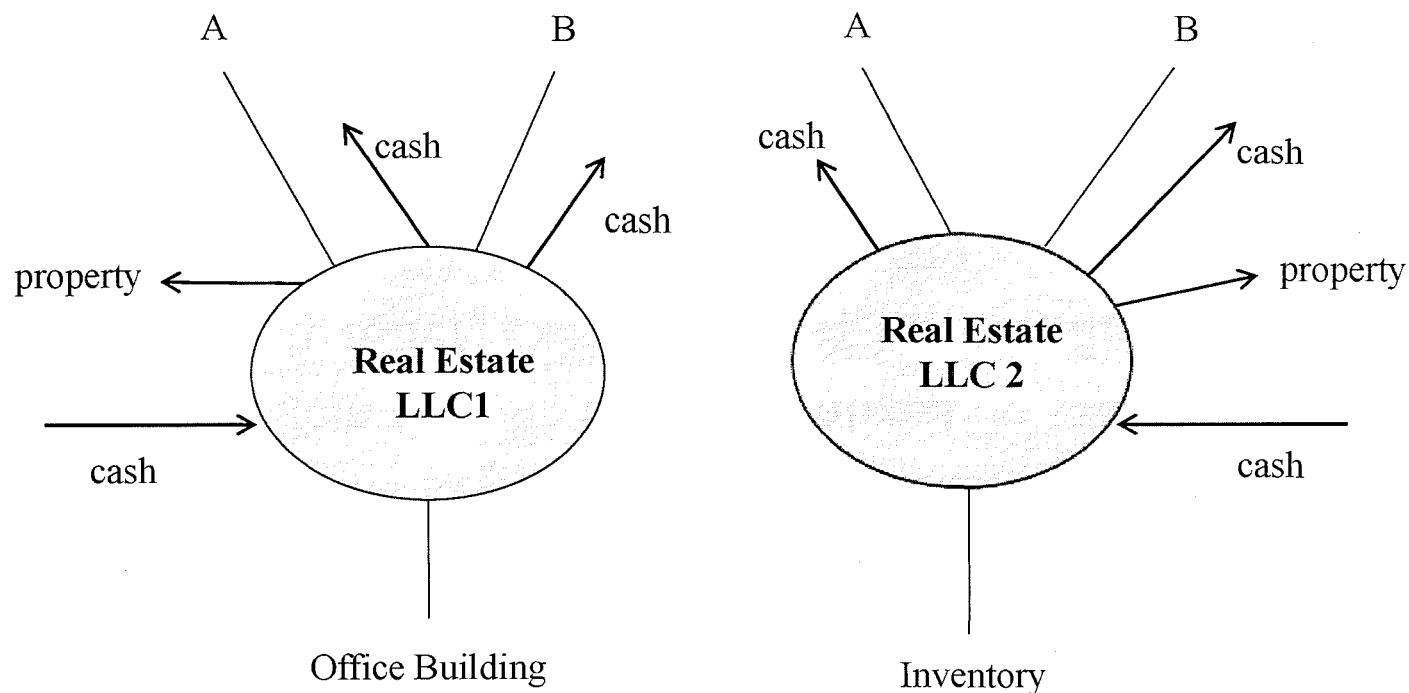
<u>A</u>		<u>B</u>	
Liabilities	800	Liabilities	800
Tax Basis	500	Tax Basis	500
Capital	(300)	Capital	(300)



Inventory

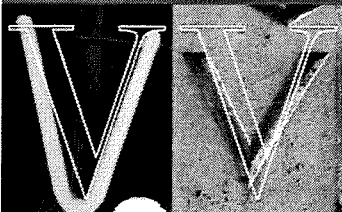
OPTION 1 – STRAIGHT SALE

What if the LLCs sold their property for cash to outside third parties and distributed the proceeds to the members?



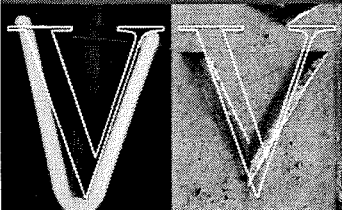
OPTION 1 – STRAIGHT SALE (cont.)

- Fully taxable transaction - each LLC will recognize gain on the sale of its property under Section 1001 to the extent that the amount realized on sale (including liability relief) exceeds the tax basis in the property
- To the extent that the property sold qualifies as a capital asset, gain or loss will be capital gain or loss
- To the extent that the property sold does not qualify as a capital asset, gain or loss will be ordinary income or loss
- If the sale generates a long-term gain, the gain will be taxed at a 15%, 25% or 28% rate under Section 1(h) depending on the circumstances



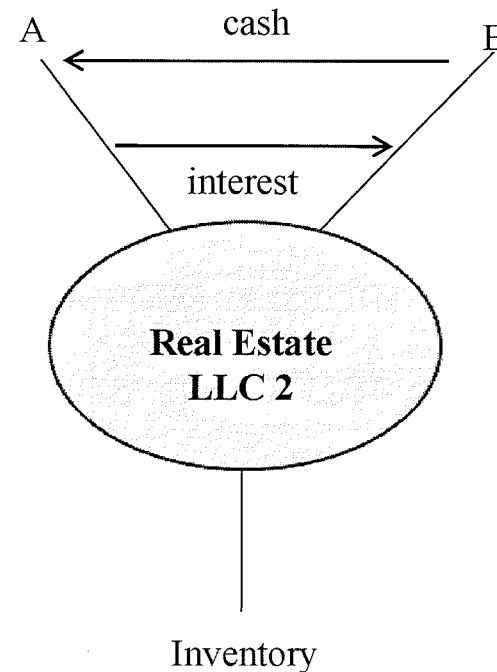
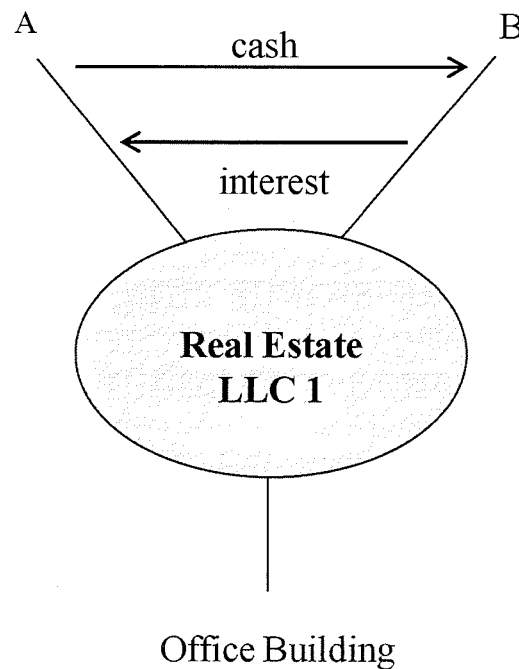
OPTION 1 – STRAIGHT SALE (cont.)

- LLC gain flows through to A and B and increases the tax basis that each partner has in its LLC interest and, therefore, generally will allow the partners to withdraw their shares of the sales proceeds without recognizing additional gain under Section 731
- State and local real property transfer taxes will need to be considered
- Can the sale of the real estate lots by LLC 2 qualify for capital gains treatment?
- After taking into account the negative capital, a straight sale option will look much less attractive



OPTION 2 – CASH CROSS PURCHASE

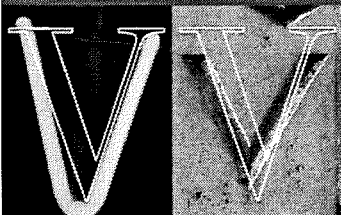
What if A buys B out of LLC 1 for cash, and B buys A out of LLC 2 for cash?

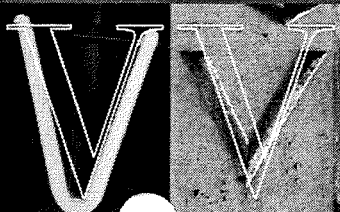


OPTION 2 – CASH CROSS PURCHASE (cont.)

Tax Consequences to Seller

- Under Rev. Rul. 99-6 (Situation 1), the Seller is treated as selling a partnership interest and thereby causing the LLC to terminate for tax purposes under Section 708(b)(1)(A)
- Seller recognizes gain on the sale to the extent that its amount realized (including liability relief) exceeds the tax basis of its LLC interest
- Gain on sale should qualify as capital gain except to the extent that the LLC holds “hot assets” and Section 751(a) applies
- To the extent that the gain qualifies as long-term capital gain, such gain will be taxed on a look-through basis at 15%, 25% or 28% under the Section 1(h) regulations





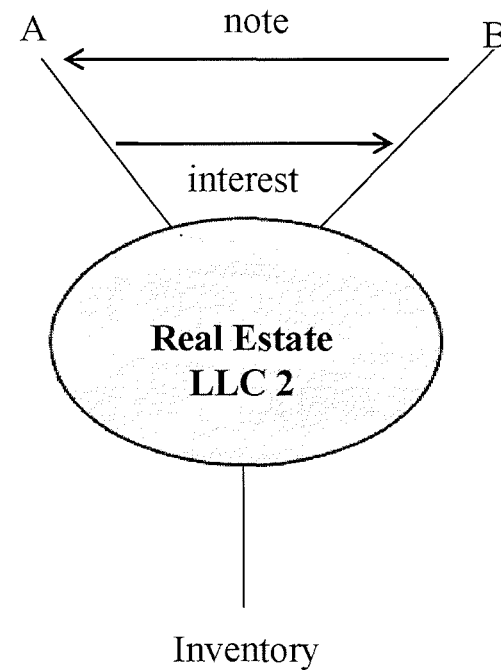
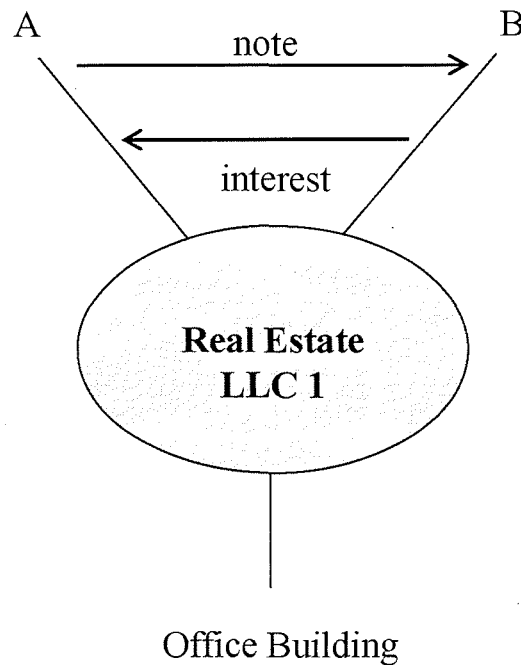
OPTION 2 – CASH CROSS PURCHASE (cont.)

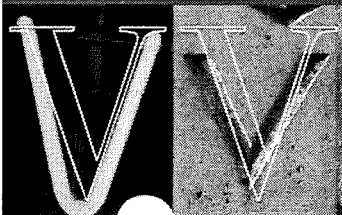
Tax Consequences to Buyer

- Buyer is treated as buying LLC assets from the Seller, in part, and receiving a liquidating distribution of assets from the LLC, in part
- Buyer receives a stepped-up tax basis in the assets deemed acquired from the Seller and a carryover tax basis in the assets deemed acquired from LLC
- Buyer also receives a new holding period in the assets deemed acquired from the Seller and a tacked holding period in the assets deemed acquired from the LLC

OPTION 3 – INSTALLMENT SALE

What if A buys B out of LLC 1 for an installment note, and B buys A out of LLC 2 for an installment note?

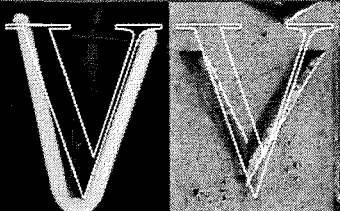




OPTION 3 – INSTALLMENT SALE (cont.)

Tax Consequences to Buyer and Seller

- The tax consequences to the Buyer and the Seller are similar to those described in Option 2 except to the extent that the installment sale rules of Section 453 apply
- If the installment sale rules apply, the Seller may be able to report all or some portion of its gain on the sale under the installment method and thereby defer all or some portion of its tax liability on the sale over the term of the installment note



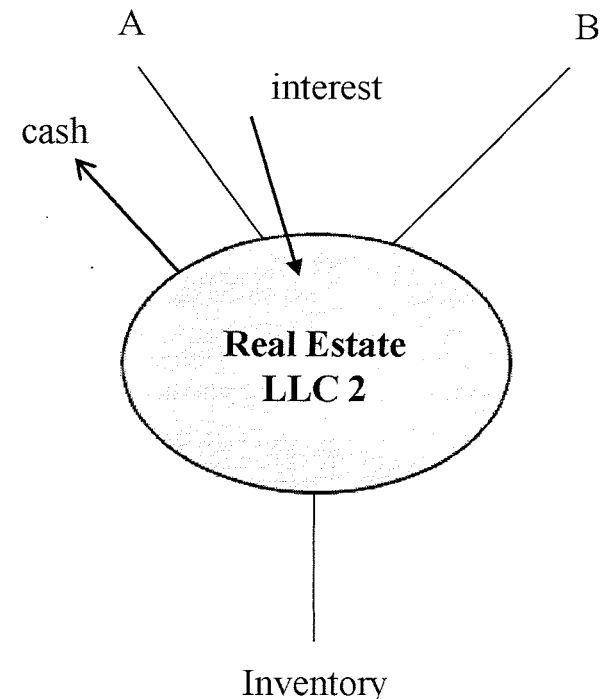
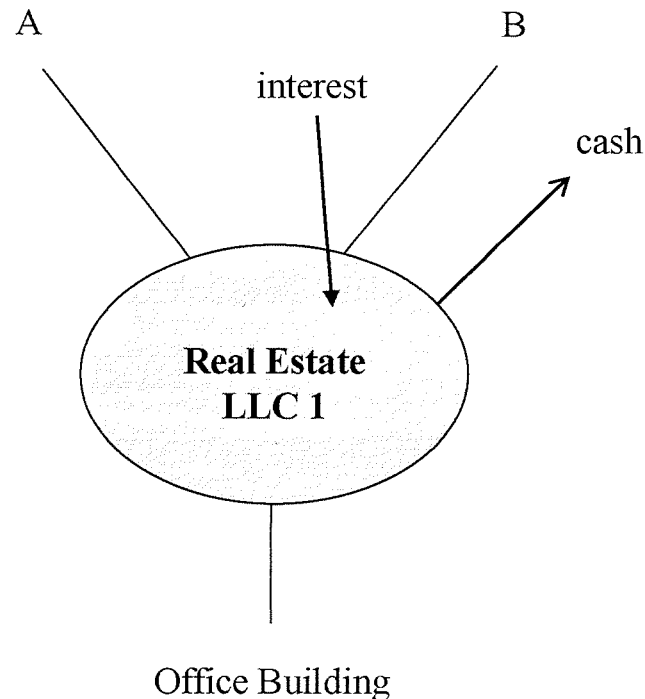
OPTION 3 – INSTALLMENT SALE (cont.)

Tax Consequences to Buyer and Seller

- A sale of an LLC interest is generally treated as a sale of an entity interest for installment sale purposes
- The IRS, however, has ruled that the sale of a partnership interest may be treated as a sale of partnership assets for installment sale purposes if the partnership holds Section 751 property. See Rev. Rul. 89-108 and CCA 200722027.
- The installment sale rules generally will not permit gain attributable to liabilities in excess of tax basis to be reported under the installment method
- Be mindful of Section 453A

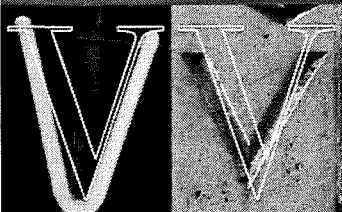
OPTION 4 – CASH REDEMPTION

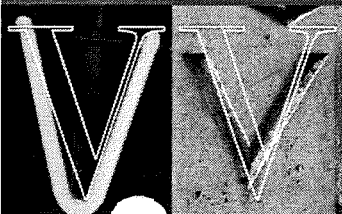
What if LLC 1 borrows money and redeems B's interest for cash, and LLC 2 borrows money and redeems A's interest for cash?



OPTION 4 – CASH REDEMPTION (cont.)

- Under Section 736(b), redemptions from partnerships in which capital is a material income-producing factor generally are taxed as distributions under Sections 731 and 751(b)
- Under Section 731, partners recognize gain if they receive cash (including deemed distributions of cash under Section 752 and certain distributions of marketable securities) in excess of the tax basis of their partnership interests. Subject to Section 751(b), this gain will qualify as capital gain.
- To the extent that a redemption results in capital gain, such gain will be taxed at 15% under the Section 1(h) regulations (using today's rates)



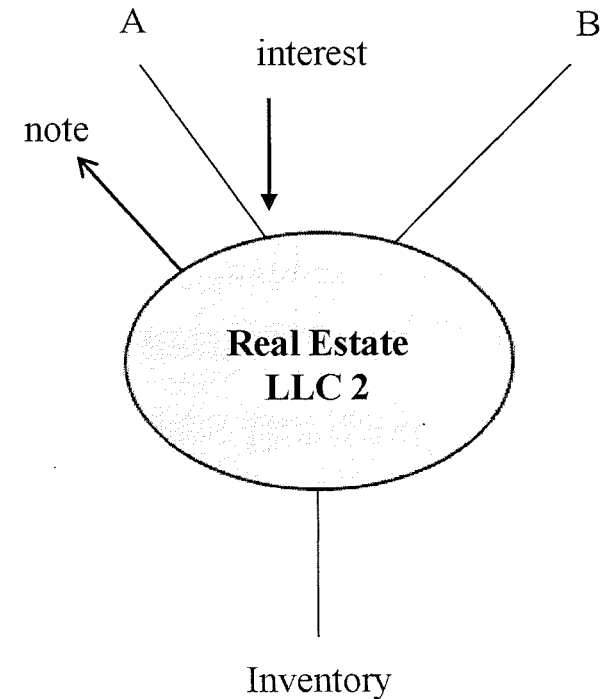
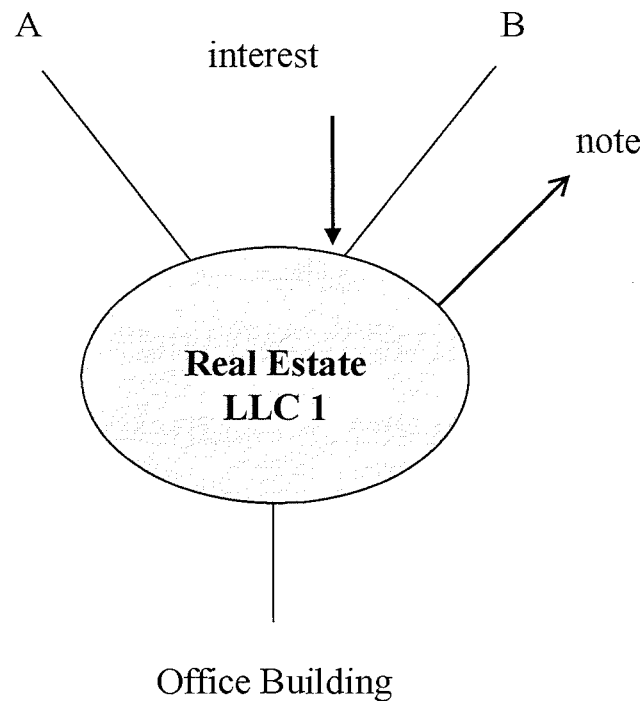


OPTION 4 – CASH REDEMPTION (cont.)

- Under Section 751(b), if a partnership holds “hot assets,” shifts in “hot” or “cold” assets can result in ordinary income recognition
- If the redeemed partner recently has contributed property to the partnership, the partner may be treated as participating in a disguised sale with the LLC under Section 707(a)(2)(B)
- The redeeming LLC can make a Section 754 election to increase the basis of any remaining partnership assets under Section 734(b)(1)(A)
- If the redeemed partner recognizes a loss, the redeeming partnership may be required to reduce the basis of its assets

OPTION 5 – INSTALLMENT REDEMPTION

What if LLC 1 redeems B's interest for an installment note, and LLC 2 redeems A's interest for an installment note?

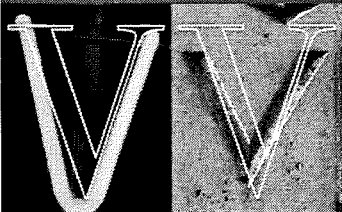


OPTION 5 – INSTALLMENT REDEMPTION (cont.)

- A partner who is redeemed for a stream of payments remains a partner for income tax purposes until the partner receives the last payment from the redeeming partnership. Regulations Section 1.736-1(a)(1)(ii).
- Practitioners generally believe that the installment sale rules of Section 453 and the original issue discount rules of Section 1274 do not apply to deferred partnership redemptions
- This means that a redeemed partner can “up-front” its basis, defer gain and avoid imputed interest on any deferred redemption payments
- How small can the continuing payments be?

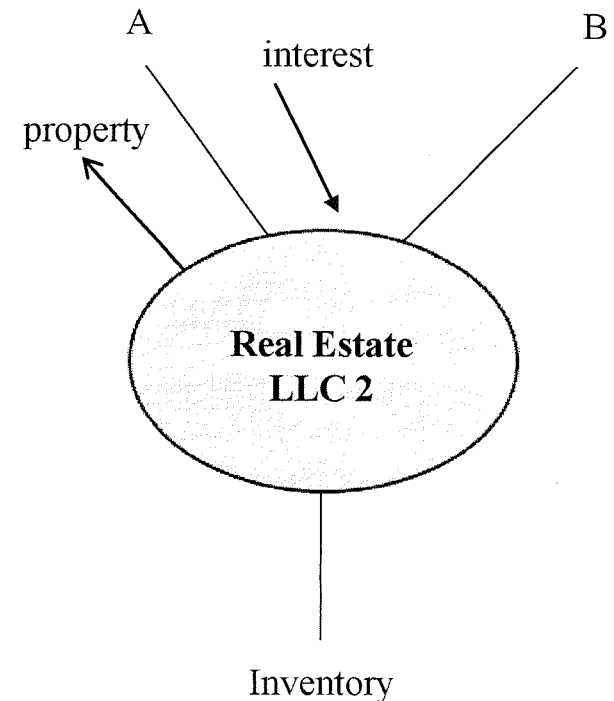
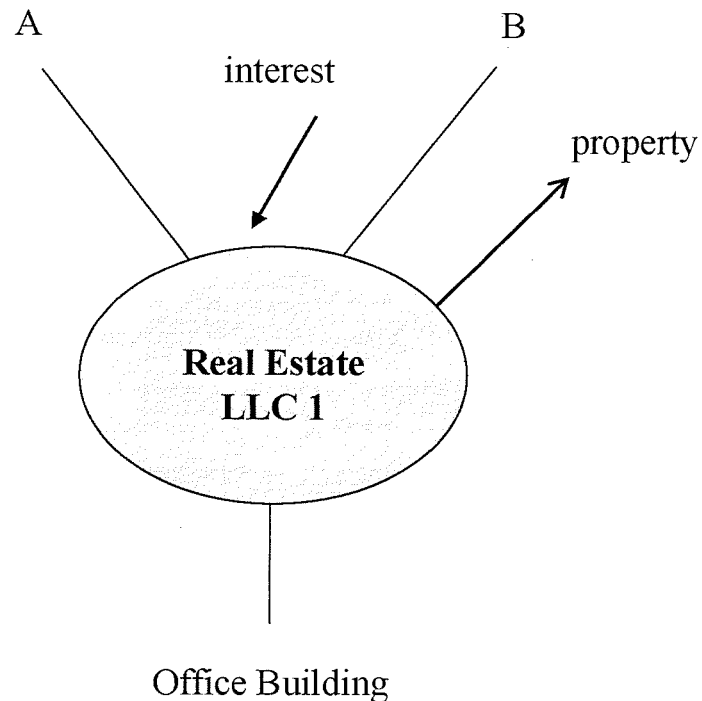
OPTION 5 – INSTALLMENT REDEMPTION (cont.)

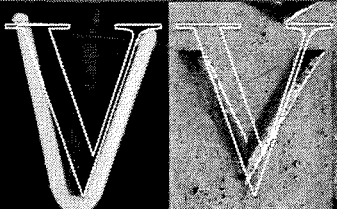
- If the redeemed partner defers gain recognition under Section 731 by “up-fronting” tax basis, any basis adjustment to partnership assets under Section 734(b) is similarly deferred
- The partnership and partner may elect to not apply up-front basis treatment in certain cases
- Redemption payments are not taken into account in determining whether the partnership terminates for tax purposes under Section 708(b)(1)(B)
- Definition of “hot assets” in the case of a redemption differs from the definition in the case of a cross purchase



OPTION 6 – PROPERTY REDEMPTION

What if LLC 1 redeems B's interest for property other than cash, and LLC 2 redeems A's interest for property other than cash?





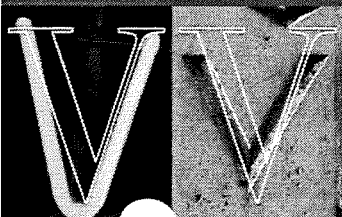
OPTION 6 – PROPERTY REDEMPTION (cont.)

- Under Section 731, partners recognize gain on partnership redemptions to the extent that they receive cash in excess of the tax basis of their interests
- Distributions of property, on the other hand, generally are tax-free to redeemed partners
- Primary exceptions to tax-free treatment for property distributions:
 - Distributions of marketable securities
 - “Mixing-bowl” rules of Section 704(c)(1)(B) and 737
 - Shifts in “hot assets” under Section 751(b)
 - Disguised sales of property by a partnership to a partner under Section 707(a)(2)(B)

OPTION 6 – PROPERTY REDEMPTION (cont.)

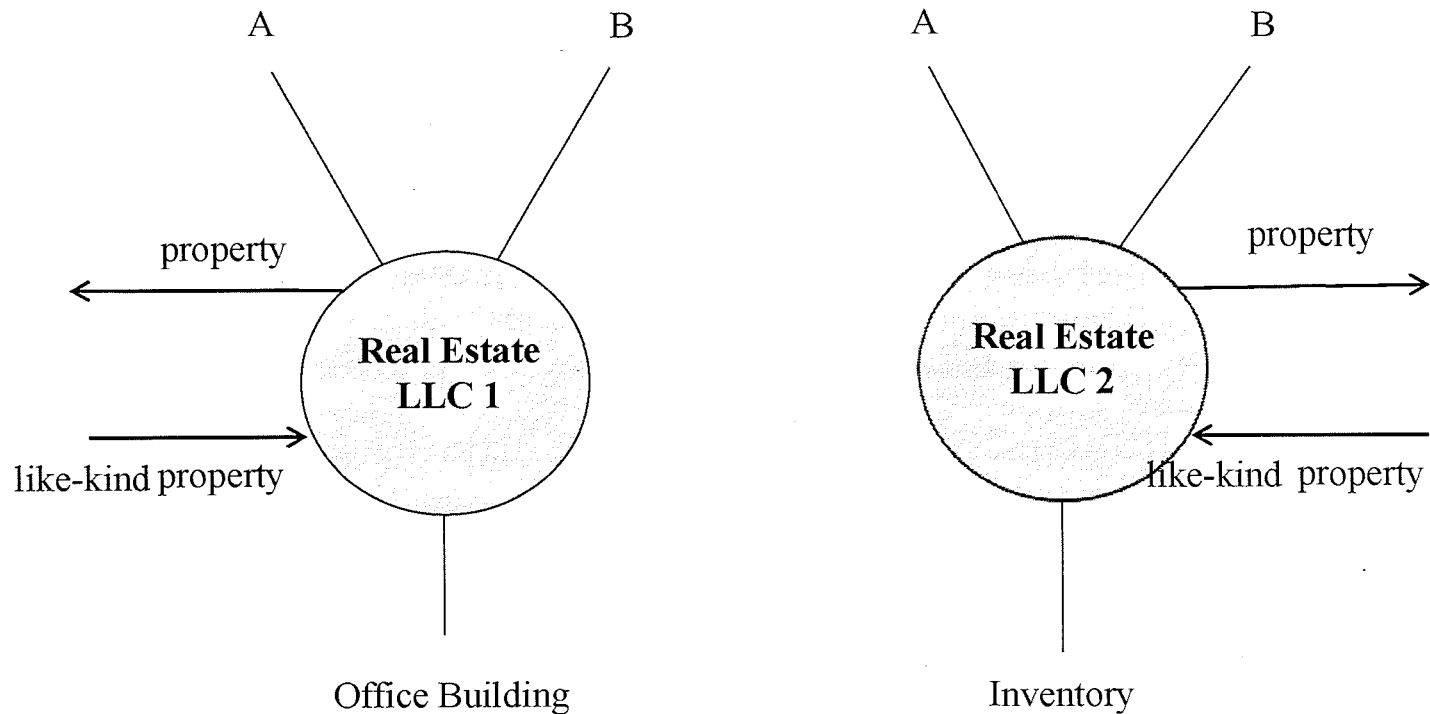
- Special disguised sale issues and concerns
 - assumptions of or taking subject to liabilities
 - disguised sale presumptions
 - disguised sales of partnership interests
 - debt-financed transfers
 - disclosures on tax returns

- What if LLC 1 acquired an outside property selected by B and subsequently used that property to redeem B, and LLC 2 acquired an outside property selected by A and subsequently used that property to redeem A? See CCA 200650014.



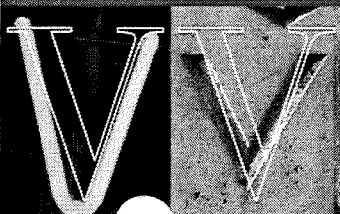
OPTION 7 – LIKE-KIND EXCHANGE

What if the LLCs entered into like-kind exchanges with third parties with the properties?



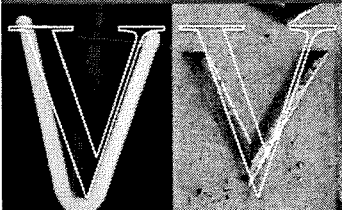
OPTION 7 – LIKE-KIND EXCHANGE (cont.)

- Under Section 1031, taxpayers can avoid recognizing gain on the sale of property used in a trade or business or held for investment if they exchange the property for property of like kind
- Property held primarily for sale to customers is not eligible for like-kind exchange treatment under Section 1031
- With LLC property, nonrecognition is available only if the LLC, as opposed to the members of the LLC, engages in the like-kind exchange



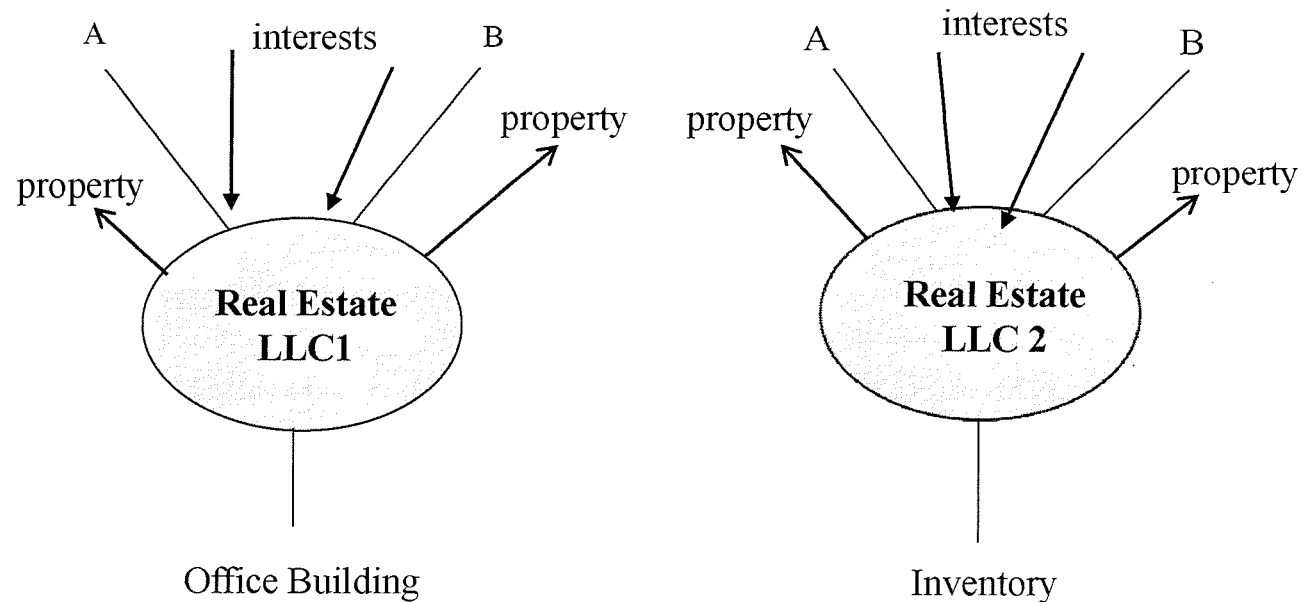
OPTION 7 – LIKE-KIND EXCHANGE (cont.)

- “Held for” issue
- Can the inventory in LLC 2 qualify for a like-kind exchange?
- Issues with liabilities – debt relief treated as “other property” but liabilities assumed can be offset against any liabilities relieved
- Issues with “boot” – gain recognized to the extent of any boot received in the exchange
- Issues with depreciation recapture



OPTION 8 – DISSOLVE AND SWAP

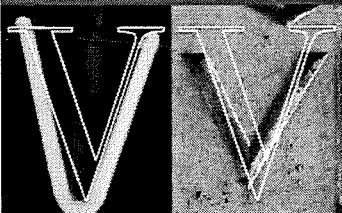
What if the LLCs dissolve, distribute their properties equally to A and B who then, after a period of time, swap the properties in a Section 1031 exchange?



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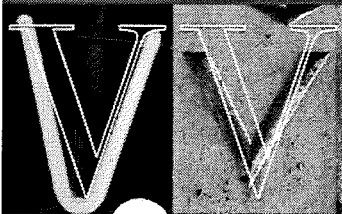


OPTION 8 – DISSOLVE AND SWAP (cont.)

- After the dissolution of the LLCs, will the co-ownership arrangements of the members be respected or will they be recharacterized as partnerships for tax purposes?
- Rev. Proc. 2002-22 provides a safe harbor for tenant-in-common arrangements, but the IRS will not issue a ruling under the Rev. Proc. if the co-owners held interests in the property through a partnership immediately prior to the formation of the co-ownership

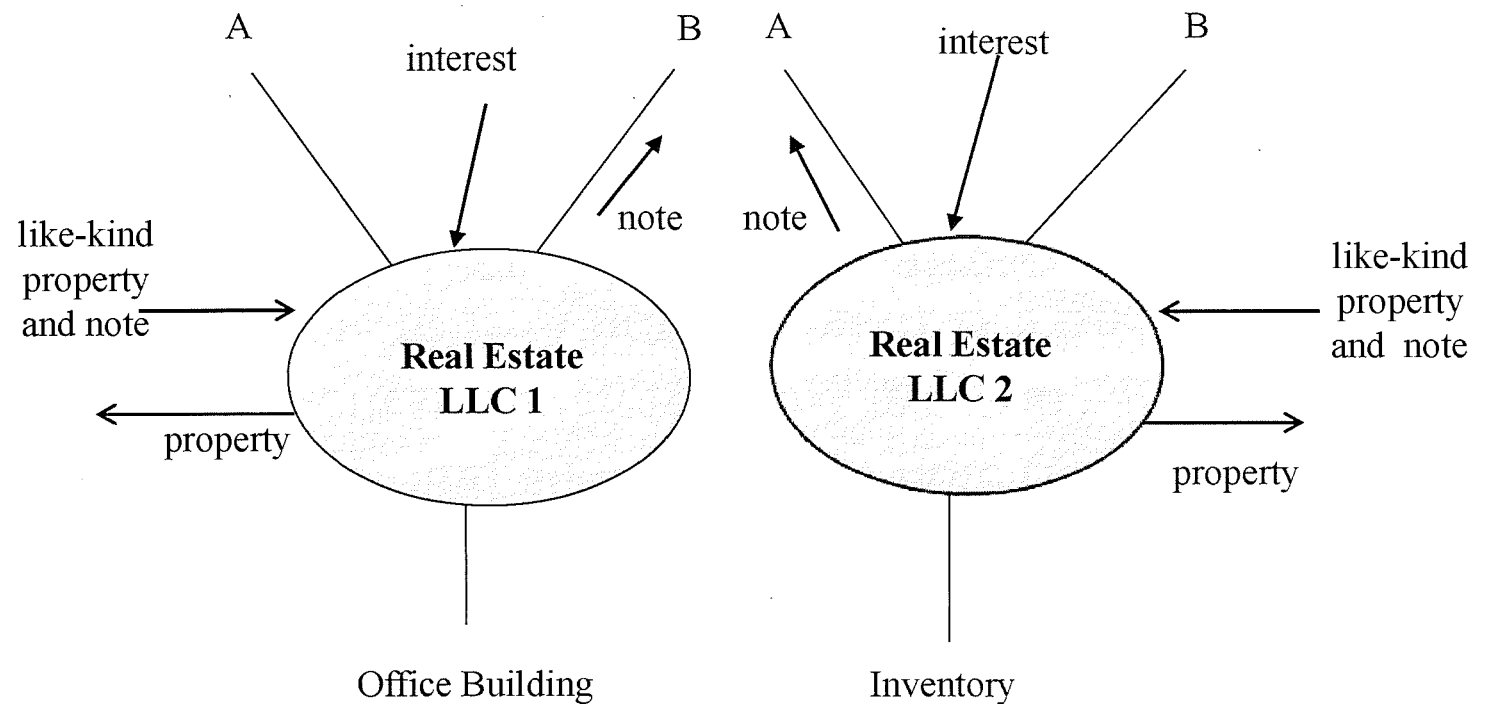
OPTION 8 – DISSOLVE AND SWAP (cont.)

- What is being exchanged – properties or partnership interests?
- For Section 1031 purposes, do A and B hold the properties “for productive use in a trade or business or for investment?”
- How much time is necessary to “hold” the property in order to qualify under Section 1031?
- Can the substance-over-form doctrine of *Commissioner v Court Holding Co.* and Rev. Rul. 75-113 be applied to the transaction?



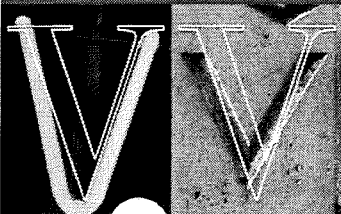
OPTION 9 – LIKE-KIND EXCHANGE WITH INSTALLMENT SALE

What if one of the LLC members wants to participate in a like-kind exchange and the other does not?



OPTION 9 – LIKE-KIND EXCHANGE WITH INSTALLMENT SALE (cont.)

- LLC 1 could transfer its property for like-kind property and an installment note (i.e., at least one payment is due in the next tax year) and distribute the note to B in liquidation of B's interest
- Similarly, if LLC 2 held qualifying property, LLC 2 could transfer its property for like-kind property and an installment note and distribute the note to A in liquidation of A's interest
- If (i) a partnership exchanges property for like-kind property and a note; and (ii) the partnership distributes the note to one partner in liquidation of its interest, the partnership may recognize no gain on the exchange or on the distribution of the note



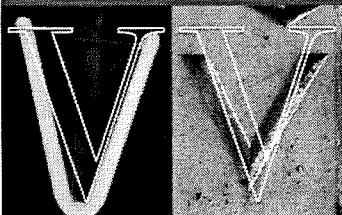
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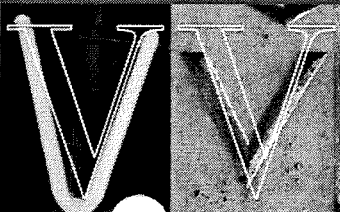
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OPTION 9 – LIKE-KIND EXCHANGE WITH INSTALLMENT SALE (cont.)

- Under proposed Section 453 regulations, the entire basis of the exchanged property is assigned to the like-kind property and the note initially receives a basis of \$0
- Upon distribution of the note, the note receives a basis in the redeemed partner's hands equal to the basis the redeemed partner had in its partnership interest before the redemption
- If the note gains basis as a result of the distribution, a basis step-down may apply to the partnership assets remaining in the partnership
- How much of the note is due in the next tax year?



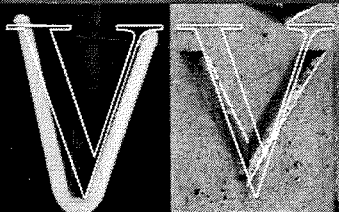


OPTION 10 – ALLOCATION SOLUTION

What if A and B recapitalized both LLCs and issued a debt-like preferred interest in LLC 1 to B in exchange for B's existing common interest in LLC 1 and issued a debt-like preferred interest in LLC 2 to A in exchange for A's existing common interest in LLC 2?

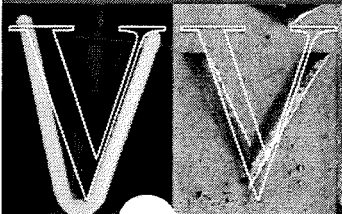
OPTION 10 – ALLOCATION SOLUTION (cont.)

- Under Rev. Rul. 84-52, an exchange of LLC common interests for LLC preferred interests should generally qualify as a tax-free exchange under Section 721
- How should the preferred interest be structured? Preferred return? Allocation of gross or net income for the preferred return? Liquidation preference? How much of a residual allocation to the preferred – 0%, 5%, 11%, 20%?
- What about property management?



OPTION 11 – MERGER APPROACH

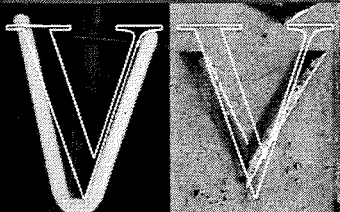
What if LLC 1 merged with and into LLC 2 (or LLC 2 merged with and into LLC 1) and, after a period of time, the combined entity dissolved and transferred the property formerly held by LLC 1 to B and the property formerly held by LLC 2 to A?



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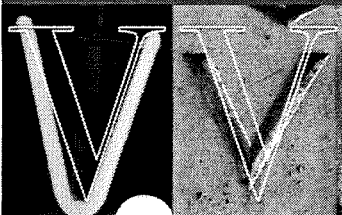
OPTION 11 – MERGER APPROACH (cont.)

- In Rev. Rul. 2004-43, the IRS concluded that a partnership merger created a new 7 year period for the combined entity under the anti-mixing bowl rules of Sections 704(c)(1)(B) and 737
- In response to public outcry, the IRS revoked Rev. Rul. 2004-43. On same day, however, the IRS issued Notice 2005-15 and stated that it would issue new regulations under Sections 704(c)(1)(B) and 737 to implement the principles of Rev. Rul. 2004-43
- The IRS issued such proposed regulations under Sections 704(c)(1)(B) and 737 in 2007 (See Prop. Reg. Sections 1.704-3 and 1.704-4)

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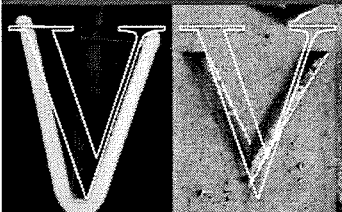


OPTION 11 – MERGER APPROACH (cont.)

- Under the proposed regulations, a partnership merger generally will create a new 7 year period for purposes of Sections 704(c)(1)(B) and 737
- However, the proposed regulations provide an exception to the creation of a new 7 year period if the merging partnerships (like LLC 1 and LLC 2 in our case) have identical ownership (or at least 97% common ownership)
- For purposes of the exception, identical ownership means identical ownership in partnership capital, partnership items, partnership distributions and partnership liabilities

OPTION 11 – MERGER APPROACH (cont.)

- Because LLC 1 and LLC 2 are identically owned, the two LLCs presumably can be merged without creating a new 7 year period under Section 704(c)(1)(B) and 737
- What if A or B independently guaranteed LLC 1 or LLC 2 debt?
- What about Sections 707(a)(2)(B) and 751(b)?



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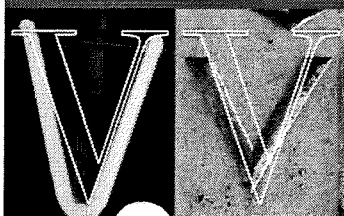
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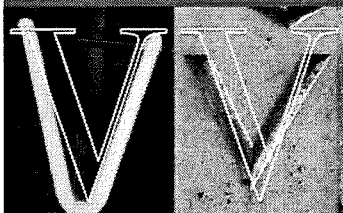
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