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Purchase and Sale of Interests; Asset and Stock Acquisitions; Redemptions; and Terminations in Pass-Through Entities

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FORTIETH WILLIAM AND MARY TAX CONFERENCE

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**PURCHASE AND SALE OF INTERESTS;
ASSET AND STOCK ACQUISITIONS; REDEMPTIONS;
and TERMINATIONS IN PASS-THROUGH ENTITIES**

by

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**I. PURCHASE AND SALE OF INTERESTS IN PARTNERSHIPS,
LIMITED LIABILITIES COMPANIES, AND S CORPORATIONS**

A. Partnerships and limited liability companies.

1. The seller's perspective.

a. Sale of interest as capital asset under § 741.

- (1) Aggregate partnership interest -- not a single unit rule.
- (2) Impact of shift in liabilities under § 752.
- (3) "Hot assets" -- deemed sale of partnership assets under § 751.

b. Installment sales.

(1) Treatment of § 751 assets.

- (a) The IRS approach -- Rev. Rul. 89-108, -- no deferral permitted on substantially appreciated inventory.
- (b) Petroleum Corp. of Texas, Inc. v. U.S., 939 F.2d 1165 (5th Cir. 1991) -- deferral permitted with allocation to ordinary income.

(2) Dealer issues.

- (a) Installment method not available for dealer property.

- (b) Allocation of sales price to dealer partnership assets. Cong. Rpt. 99-841, 99th Cong. 2nd Sess. 299.
- (3) Relief of liabilities treated as money taxable to partner to the extent it exceeds basis. Rev. Rul. 77-483, 1976-2 C.B. 131
- (4) Negative capital account triggered -- query uses of wraparound sale.
- (5) § 453A(c) interest charge issues.
- c. Impact on suspended losses.
 - (1) § 704(d) losses in excess of basis.
 - (2) § 465 at-risk losses.
 - (3) § 469 passive activity losses.
- d. Related party rules under §§ 707(b)(1) and 267(d).
- e. Like kind exchanges.
 - (1) Exchange of partnership interests prohibited. § 1031(c)(2)(D)
 - (2) Pre-contribution or post-distribution exchanges of property. See Magnuson v. Comm., 753 F.2d 1490 (9th Cir. 1985); Mason v. Comm., T.C.M. 1988-273.

2. The buyer's perspective.

- a. Buyer's basis and acquired attributes.
 - (1) Cost basis.
 - (2) Inherited capital account.
 - (a) Potential for phantom income, even if § 754 election in effect, e.g., repayment of loan principal.
 - (b) Application of minimum gain chargeback to buyer.
- b. Inside basis adjustments to partnership property under §§ 754 and 743.

- (1) Conversion of § 197 intangibles (e.g., goodwill) from non-amortizable to amortizable assets.
- (2) Impact on ACRS depreciation.
- (3) Special basis is "outside" -- what happens if buyer is later redeemed out.
- (4) The administrative burden of applying § 754.
- (5) Other significant issues.
 - (a) Allocation of income.
 - (i) Interim closing of books. § 706(c)
 - (ii) Cash basis item accruals. § 706(d)
 - (b) Termination of partnership year -- 50% change in interest -- § 708. See §§ 707(a) and 737.
 - (c) Abandonment of partnership interest as ordinary loss or capital loss. See, Rev. Rul. 93-80, 1993-38 I.R.B. (5 Nov. 29), Echols v. Comm., 935 F.2d 703 (5th Cir. 1991); and Citron v. Comm., 97 T.C. 200 (1991).
 - (d) Potential impact on partnership tax status (e.g., transfer of general partnership interest to new partner with nominal net worth).

B. Purchase or sale of stock in an S Corporation.

1. Impact of shareholder buy-sell agreement.
2. Risk of loss of status as "small business corporation" (e.g., ineligible shareholder or over 35 shareholders).
3. Seller's perspective.
 - a. Generally capital gain or loss under § 1001 et seq.
 - (1) Separate share basis rule.

- b. Comparison with partnerships and limited liability companies.
 - (1) No "hot asset" conversion of gain to ordinary income. Compare § 742.
 - (2) No attribution of corporate liabilities to shareholders and therefore no deemed release of liabilities to shareholder. Compare § 752.
 - (3) No capital account or minimum gain chargeback issues.
 - c. Treatment of suspended losses.
 - (1) § 1366(d) losses and excessive basis.
 - (2) § 465 at-risk losses.
 - (3) § 469 passive activity losses.
- 4. Buyer's perspective.**
- a. Basis an acquired attributes.
 - (1) Cost basis to purchasing shareholder.
 - (2) No entity inside basis adjustment rules. Compare §§ 754 and 743.
 - b. The corporate Accumulated Adjustments Account ("AAA") is not affected by shareholder sale.
- 5. Allocation of income.**
- a. Generally income is allocated on a per-day, per-share rule. § 1366(a)
 - b. Gain to seller affected by basis adjustments for income or loss allocations prior to sale.
 - c. Election to close books.
 - (1) Election based on termination of interest. § 1377(a)(2)
 - (2) Election based on disposition of 20% of corporate shares within 30-day period. Treas. Reg. § 1.1368-1(g)(2)

II. THE PURCHASE AND SALE OF A BUSINESS

A. Partnerships and limited liability companies.

1. Sale of assets -- the seller's perspective.

- a. Normal tax rules of subchapter K apply. Recognized gains and losses will retain character and pass through to partner or member. §§ 701-704.
- b. Sale of business as sale of separate assets. Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945); James v. Johnson, 49 T.C. 324 (1968), Rev. Rul. 68-13, 1968-1 C.B. 195.
- c. Release of liabilities as amount realized. Treas. Reg. § 1.100-2, § 7701(g), Crane v. Comm., 331 U.S. 1 (1947).
- d. Ordinary income recaptures. §§ 1245 and 1250.
- e. Installment sale of deferral. § 453.
 - (1) Assumption of liabilities as payment in year of sale.
 - (2) Recapture income. § 453(i).
 - (3) Dealer property and inventory exclusions. § 453(b)(2)(A) and § 453(l).
 - (4) Interest charges. § 453A(c).
 - (5) Subsequent distribution of installment obligation is not a disposition under section 453B. Treas. Reg. § 1.453-9(c)(2). Gain reported as received measured by reference to investor's basis, § 732, Treas. Reg. § 1.453-9(c)(3).
 - (6) Use of wraparound mortgage to preserve negative capital account. Professional Equities, Inc. v. Comm., 89 T.C. 165 (1987) (Treas. Reg. § 15A, 453-1(b)(3)(ii) held invalid). Stone Crest v. Comm., 24 T.C. 659 (1955).

2. Sale of assets - the buyer's perspective.

- a. Cost basis on purchase of assets.

- b. Allocation of purchase price in applicable asset acquisition. § 1060.
- 3. Tax-free reorganizations.**
- a. Absence of special code provisions governing reorganizations. Compare §§ 354-368.
 - b. Inter-partnership exchanges.
 - (1) Contribution (exchange) of limited partners interest to another limited partnership. Rev. Rul. 84-115, 1984-2 C.B. 118; § 721.
 - (2) Conversion to limited partnership. Rev. Rul. 84-52, 1984-1 C.B. 157; P.L.R. 9132042.
 - (a) Change in liabilities. § 752.
 - (b) Holding period. § 1223(1).
 - (c) Dissolution of equity? § 708. No sale or exchange. See Treas. Reg. § 1.708-1(b)(1).
 - (3) Conversion of partnership to LLC P.L.R. 9350013.
- 4. Incorporation of partnership or LLC.**
- a. Flexibility permitted in planning. Methods selected by parties will be respected. Rev. Rul. 84-111, 1984-2 C.B. 88.
 - (1) Contribution of entity assets to corporation in exchange for stock followed by distribution of stock in liquidating distribution.
 - (2) Liquidation of partnership or LLC followed by contribution of undivided interests in properties to the corporation in exchange for stock.
 - (3) Contribution by partners or members of investor interests to corporation for stock.
 - b. Taxable transaction upon exchange of partner's or member's interest for corporate stock. § 1001.

- c. Nontaxable transfer to corporation.
 - (1) Transfer to controlled corporation. § 351.
 - (a) Partnership interest as "property" Rev. Rul. 84-111, 1984-2 C.B. 88, Rev. Rul. 81-38, 1981-1 C.B. 386.
 - (b) 80% control issue. § 368(c) compare § 721.
 - (c) Assumption of liabilities. transferor's share of liabilities subject to § 357.
- d. Transferor's basis in corporate stock received.
 - (1) In exchange for partnership interest.
 - (2) Based upon property received in distribution from partnership or LLC. § 732(a) or (b).

B. Business acquisitions and dispositions involving S corporations.

1. Technical planning issues.

- a. Protection of S corporation status as electing small business corporation. § 1361.
 - (1) Shareholder eligibility limited to individuals, estates and certain trusts; e.g., exclusion of corporations, partnerships.
 - (2) One class of stock rule.
 - (3) Size limited to 35 shareholders.
 - (4) Nonresident alien prohibition.
 - (5) Restriction agreement participation in an affiliated group of corporations, or as an "ineligible" corporation.
- b. Controlling termination of election. § 1362(d).
 - (1) Revocation.

- (2) Ceasing to be a small business corporation.
- (3) Three year excess passive investment income rule.
- (4) Five year re-election rule. § 1362(g).

c. Coordination with subchapter C.

- (1) Application of subchapter C to S corporation and its shareholders, except to extent inconsistent. § 1371(a)(1).
- (2) Requirement that S corporation in its capacity as a shareholder be treated as an individual. § 1371(a)(2).

2. Coordination between subchapter S and subchapter C.

a. S corporation as a purchaser of stock. (non-reorganization).

(1) Eligibility issues.

- (a) Violation of affiliated group participation rule. § 1361(b)(2). momentary control permitted. Rev. Rul. 72-320, 1972-1 C.B. 270; Rev. Rul. 73-496; 1973-2 C.B. 320.

- (i) Subsidiary holding period. One day rule. Rev. Rul. 73-496, 1973-2 C.B. 320 (30 days); Haley Bros. Construction Co. Corp. v. Comm., 87 T.C. 498 (1986). G.C.M. 39768 (Dec. 1, 1988); P.L.R. 8920004.

(2) Liquidation issues.

- (a) Non-controlling liquidation. §§ 331, 336 and 1371(a)(1).

- (b) Liquidation of controlled subsidiary. §§ 332 and 337.

- (i) S corporation as a "controlling corporation."

- (ii) Anti-affiliation rule and S corporation shareholder as an individual rule.

§§ 1361(b)(2), 1371(a)(2),
Rev. Rul. 73-496, 1973-2 C.B.
320, P.L.R. 8818049, T.A.M.
9245004 (July 28, 1972).

(3) Basis in assets acquired.

(a) Transferred basis. § 334(b).

(b) Purchase of stock followed by liquidation cannot be treated as an asset acquisition. Rev. Rul. 90-95 1990-2 C.B. 67. Kimball Diamond Milling Co. v. Comm., 14 T.C. 74.

(c) Election to step up basis. § 338.

(i) C corporation as "purchasing corporation". § 338(d)(1); § 1371(a)(2). P.L.R. 8818049; T.A.M. 9245004; P.L.R. 9325006.

b. S corporation as the target in stock acquisition. (non-reorganization).

(1) S corporation with transitory corporate shareholders. P.L.R. 8739010. Rulings disregard transitory ownership.

(2) Election to disregard stock purchase and treat transaction as sale of assets by the target S corporation § 338 (h)(10), Treas. Reg. § 1.338 (h)(10)-1(a).

(a) Joint election available on purchase of stock from a member of a consolidated group.

(b) Opportunity - gain on deemed sale of assets offset by other selling group attributes or when inside basis of target assets exceeds the parent company's basis in the target's stock.

(c) S corporation shareholders may make a § 338(h)(10) election. Target S deemed to have sold all assets and distributed proceed to its shareholders in complete liquidation, Treas. Reg. § 1.338(h)(10) - 1(a).

c. Tax free transactions.

- (1) Reorganizations under § 368. An S corporation may be a party to an "A", "C", "D", or "F" reorganization. G.C.M. 39768 (Dec. 1, 1988).
 - (a) C corporation as target. Transitory violation of anti-affiliation and corporate shareholder rules disregarded. G.C.M. 39768 (Dec. 1, 1988), Rev. Rul. 72-320, 1972-1 C.B. 270.
 - (b) S corporation as purchaser. § 1371(a)(2) disregarded in recognizing S corporation as corporation; Anti-affiliation rule disregarded. G.C.M. 39768 (Dec. 1, 1988) Rev. Rul. 69-566, 1969-2 C.B. 165 ("A" merger).
 - (c) S corporation cannot participate effectively in a "B" stock for stock reorganization or a forward or reverse subsidiary merger under § 368(a)(2)(D) or (E) because of continued affiliation problems.
 - (d) Divisive "D" reorganization and § 355. Rev. Rul. 72-320, 1972-1 C.B. 270. P.L.R. 9414016 and P.L.R. 9403031.

3. Taxable acquisitions - S corporation as purchaser.

- a. Taxable stock acquisition with carryover basis in assets.
 - (1) Momentary affiliation -- must immediately liquidate the target. §§ 332, 337, 334(b) and 381.
 - (2) Built-in gain application to acquired assets. § 1374(d)(8).
 - (3) Carryover of corporate attributes includes subchapter C earnings and profits. § 381(c)(2).
 - (a) Resulting application of passive investment interest rules. §§ 1362(d)(3) and 1375.

- (4) Allocations in the event of termination of S election.
 - (a) Per day rule between S short year and C short year. § 1362(e).
 - (b) Closing the books.
 - (i) Required for S termination year if there is 50% change in the S corporation ownership. § 1362(e)(6)(d).
 - (ii) Elective if S corporation issues new stock equal to 25% of outstanding stock. Treas. Reg. § 1.1368-1(g)(2).
- (5) Reverse subsidiary merger ("purchasers transitory subsidiary merged into target) followed by liquidation or merger of purchaser and target treated as stock acquisition. Rev. Rul. 90-95, 1990-2 C.B. 67; Rev. Rul. 79-273, 1979-2 C.B. 125.

b. Taxable asset acquisition -- S corporation as purchaser.

- (1) S corporation takes cost basis in either asset purchase or forward cash merger (target merges into purchaser with target shareholders receiving cash. Rev. Rul. 69-6, 1969-1 C.B. 104

4. Taxable acquisitions - S Corporation as target.

a. Taxable stock sale - S Corporation as target.

- (1) Tax reasons for stock sales.
 - (a) Existence of §1374 assets.
 - (b) Higher basis in stock.
 - (c) Substantial corporate ordinary income assets.
- (2) Impact on S election.
 - (a) Loss of "small business corporation" status.

- (b) Anti-affiliation rule - Rev. Rul. 73-496, 1973-2 C.G. 312, T.A.M. 9245004.
 - (3) Allocations in the event of termination of the election.
 - (a) Per day rule. § 1362(e)
 - (b) Closing the books.
 - (i) Required for S corporation termination if 50% change. § 1362(e)(6)(D)
 - (ii) Elective if termination of shareholder interest, or substantial change in ownership. § 1377(a)(2); Tres. Reg. § 1.1368-1(g)(2)
 - (4) Post termination distributions permitted. §1371(e)
 - (5) Pre-sale distribution opportunities.
 - (6) Availability of installment sales.
 - (7) QSST stock. Beneficiary is taxed on gain from sale of stock by trust. Rev. Rul. 92-84 1992-40, I.R.B. 24. Allocation to Corpus issue.
 - (8) Merits of § 338 election on termination? Since corporation would be treated as a C Corporation on date of acquisition/termination, gain on assets would be taxed to target on single day as C Corporation. §§ 1368(e)(1)(B) and 338(a)(1). Thus both gain on stock and assets taxed. Problem avoided under § 338(h)(10) election.
- b. Taxable asset acquisitions. - S Corporation as target.
- (1) Reasons for asset sale.
 - (a) Inside asset basis as high as stock basis.
 - (b) Minimal §1374 risk.

- (c) Most assets entitled to capital gain treatment.
- (2) Corporate level income.
 - (a) Built-in gain assets from C corporation status.
 - (b) Passive investment income risk if subchapter C earnings and profits acquired.
- (3) Installment notes. Distribution of note in liquidation within 12 month period. §§ 453B(h) and 453(h)(1).
- (4) Sale of stock with a § 338(h)(10) joint election as deemed asset sale.

5. Tax-free acquisitions involving S corporation.

An S corporation may be a party an "A", "C", "D" or "F" reorganization. G.C.M. 38768 (Dec. 1, 1988). A "B" reorganization or a merger under § 368(a)(2)(E) or (D) create affiliated corporation problems.

a. Tax-free stock acquisition.

- (1) "B" reorganization and tax-free forward and reverse subsidiary mergers. §§ 368(a)(1)(B), (2)(B) and (2)(D).
- (2) Stock exchange with S corporation as purchaser or target will cause continued affiliation or eligible shareholder problem.
- (3) Allocation on termination of election required; pro-rata or closing of books.
- (4) Post termination distribution and use of suspended excess losses.

b. Tax-free asset acquisitions.

- (1) "A" reorganizations.
 - (a) Approved for S corporation survivor. Rev. Rul. 69-566, 1969-2 C.B. 165; P.L.R. 9410022.

- (b) Approved for S corporation target Rev. Rul. 64-94, 1964-1 C.B. 317; P.L.R. 8502082.
 - (c) Approved consolidation of two S corporations, Rev. Rul. 70-232, 1970-1 C.B. 177.
- (2) "C" reorganizations. Approved in G.C.M. 39768 (Dec. 1, 1988).
 - (3) "D" reorganization. Approved in Rev. Rul. 73-496, 1973-2 C.B. 320.
- c. Check points for S corporation purchase in a reorganization.
- (1) Risks to continued eligibility.
 - (a) Affiliation issues. Acquisition of stock of target subsidiaries.
 - (b) Transfer of purchaser's stock to ineligible shareholder by target.
 - (c) Avoiding 35 shareholder limit.
 - (d) Avoiding second class of stock in structuring reorganization.
 - (2) Allocation of income.
 - (3) Carryover of attributes. § 381.
 - (a) Built-in gain assets. § 1374.
 - (b) LIFO recapture rule. § 1363(d), Treas. Reg. § 1.1363-2(a)(2).
 - (c) NOL not carried over, but available to offset § 1374 gain. §§ 1371(b)(1) and 1374(b)(2).
 - (d) Treatment of distributions in a reorganization. § 1368 or § 356.
- d. Check points for S corporation target in a tax-free asset acquisition.
- (1) Target S corporation ceases to exist in an "A", "C" or "D" reorganization upon merger or liquidation. G.C.M. 39768 (Dec. 1, 1988). This is not a termination preventing the purchaser from

electing subchapter S treatment immediately. § 1362(g).

- (2) Allocations -- Since there is no "termination" under § 1362, the Short S year includes the date of reorganization.
- (3) Attributes carried over. § 381
 - (a) Merger of AAA upon merger of two S corporations. Treas. Reg. § 1.11368-2(d)(2).
- (4) Post acquisition distributions.

III. RETIREMENT OF INTEREST

A. Partnerships and limited liability companies.

1. Distributions in retirement of interest.

a. The seller's perspective.

- (1) Payment in exchange for interest as distribution under § 731(a).
 - (a) Gain generally not recognized.
 - (i) Exception for money in excess of basis.
 - (ii) Impact of reduction in liabilities. § 751.
 - (iii) GATT provision regarding marketable securities as "money".
 - (b) Losses generally not recognized. § 751(a)(2).
 - (i) Distributions of only money, realized receivables and inventory.
 - (ii) Recovery of passive activity losses on liquidation of interest.
 - (iii) Comparison with installment sales. § 731 versus § 453.
- (2) Distributions in kind from perspective of selling partner or member.

- (a) Special items and § 751 hot assets.
 - (i) Inventory.
 - (ii) Unrealized receivables.
 - (iii) Goodwill.
- (b) General partner in service partnership. § 736(b)(3)
 - (i) Capital as material income-producing factor.
 - (ii) Unrealized receivables.
- (3) Treatment of basis in property received by selling partner or member.
 - (a) Basis for property acquired in non-liquidating distributions. § 732(a) -- the transferred basis rules.
 - (b) Basis for property acquired in liquidating distributions. § 732(b) -- the substituted basis rules.
 - (c) Basis allocation rules.
 - (i) Treatment of inventory and unrealized receivables.
 - (ii) Treatment of other properties.
 - (iii) Special basis allocation adjustments. § 732(d).
 - (d) Preserving negative capital accounts.

b. The partnership or LLC's perspective.

- (1) Income shifting and deduction opportunities under § 736(a).
 - (a) Payment of distributive share of entity income. § 736(a)(1).
 - (b) Guaranteed payments. § 736(a)(2).
 - (c) Application to general partner of service partnership.

- (i) Goodwill.
- (ii) Unrealized receivables.
- (2) Special entity basis adjustments. §§ 734, 754 and 755.
- (3) Basis strips -- use of §§ 732 and 754.
- c. Abandonment or worthlessness of interest.
 - (1) Ordinary loss treatment. Rev. Rul. 93-80, 1993-38 I.R.B. 5 (November 29, 1993); Rev. Rul. 70-355, 1970-2 C.B. 51, Tejon Ranch Co. v. Comm., T.C.M. 1985-207, 49 T.C.M. 1375, Citron v. Comm., 97 T.C. 200 (1991).
 - (2) Sale or exchange treatment under § 731.
 - (a) Impact of release of liabilities. O'Brien v. Comm., 77 T.C. 113 (1981); Yarbro v. Comm., 737 F.2d 479 (5th Cir. 1984).
 - (b) Evidence of abandonment. Echols v. Comm., 935 F.2d 703 (5th Cir. 1991); Citron v. Comm., 97 T.C. 200 (1991).
- d. Distributions of property previously contributed within five years.
 - (1) Property contributed by remaining partner or member. § 704(c)(1)(B).
 - (2) Property contributed by withdrawing partner or member. § 737.

B. S Corporations.

1. Selling shareholder's perspective.

a. Tested as redemption of interest.

- (1) Capital gain treatment.
 - (a) Application of § 302(a) and § 1371(a)(1). See P.L.R. 85320886, P.L.R. 90210526
 - (b) Ordinary income from dealer property, § 306 stock, or collapsible corporation transaction.

- (2) Capital loss on stock.
 - (a) Shares can qualify under § 1244. Loss attributable to increase in basis from flow-through of income does not qualify. Treas. Reg. § 1.1244(d)(2)(A).

- (3) Basis adjustments.

- (a) Impact of pre-redemption income. § 1367 and Treas. Reg. § 1.1367-1(d)(1).
- (b) Closing of books.
 - (i) Termination of interest. § 1377(a)(2)
 - (ii) Disposition of substantial interest. Treas. Reg. § 1.1368-1(g)(2).

- b. Distribution not taxable as redemption.

- (1) Nontaxable distributions under § 1368(a).
- (2) Distributions in excess of AAA. § 1368(c). Dividend treatment under § 1368(c)(2), § 301, and § 316.

- 2. The redeeming corporation's perspective.

- a. Cash distributions.

- b. Property distributions.

- (1) Loss not recognized to the corporation. § 311(a).
- (2) Gain recognized to corporation. § 311(b).
 - (a) Pass through to shareholders. § 1366.
 - (b) Recognized built-in gain to the corporation. § 1374.
- (3) Planning opportunity. Gain to corporation which is passed through to the shareholder increases shareholder basis. Therefore the seller's gain on redemption is reduced because of the

increased basis. Remaining shareholders avoid tax on redeeming shareholder's share of gain at expense of current taxation.

- c. Changes to the Accumulated adjustments account. § 1368(e)(1)(B); Treas. Reg. § 1.1368-2(d).

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