

ISSUES TO CONSIDER IN STRUCTURING A PARTNER BUY-OUT: SALE VERSUS REDEMPTION

ABC LLC is owned equally by individuals A, B, and C. C wishes to retire from the partnership. Should he sell his interest equally to A and B or should the partnership redeem C's interest? The following table discusses issues to consider when advising our clients on the proper way to structure such a transaction. (Disclaimer: this table anticipates a sale or redemption at FMV on terms that would be agreeable to a willing buyer and willing seller.)

ISSUE TO CONSIDER	SALE	REDEMPTION
Governing Code Section(s)	§741, §751	§736, §751

IMPACT ON DEPARTING PARTNER		
Will the sale generate ordinary income or capital gain?	Both. Ordinary income to the extent of the partner's share of any gain attributable to "hot assets". Capital gain or loss for the remainder under §741. ¹	Both. Ordinary income to the extent of the partner's share of any gain attributable to "hot assets." Capital gain or loss for remainder under §736. ²
Does the partnership have inventory?	All inventory, regardless of whether it is substantially appreciated, is considered a "hot asset."	Inventory is a "hot asset" only when the FMV of all inventory items exceed the partnership's aggregate tax basis in such items by more than 20%. ³
When is ordinary income from "hot assets" recognized?	In year 1 even if partnership interest is sold on the installment method under IRC §453. ⁴	In year 1, but limited to cash received plus debt relief in year 1.
Can a departing partner recognize an ordinary loss on inventory "hot assets?"	Yes, if inventory has a basis in excess of its FMV.	No, because inventory is only a hot asset if it is substantially appreciated.
Does the partnership have assets that, if sold, would generate unrecaptured §1250 gain taxed at 25%?	Seller is forced to "look through" to his share of the partnership's §1250 gain and pay 25% tax on this amount. ⁵	In a redemption, the departing partner is NOT required to pay 25% tax on his share of the partnership's unrecaptured §1250 gain. ⁶
How is basis recovered if the departing partner receives payments beyond the year of sale?	Unless the partner elects out, he would generally report the sale of the non- "hot assets" on the installment method. As a result, basis would be allocated according to the installment sale rules to each payment received.	After considering the impact of hot assets, the partner is permitted to recover his full partnership basis prior to recognizing any additional capital gain. ⁷ Conversely, a capital loss cannot be recognized until the final payments have been made, as that is when it becomes "fixed."
If payments for the departing partner's interest are made in installments extending beyond one year, must interest be computed on the deferred payments?	Any deferred payments must provide for adequate interest or interest will be imputed under the OID rules.	Installment payments are not subject to the OID rules so the payments can include no interest or below-market interest. ⁸
When are liabilities deemed relieved of and included in the amount realized of the seller?	In the year of sale, regardless of whether deferred payments are to be made.	In the year of initial sale, unless the redeemed partner continues to bear the economic risk of loss with respect to partnership recourse debt as deferred payments are made. ⁹

¹ "Hot assets" include unrealized (cash basis) receivables, inventory, and depreciation recapture subject to ordinary income. (§751(a)(2))

² In a redemption, "hot assets" include unrealized (cash basis) receivables, substantially appreciated inventory, and depreciation recapture subject to ordinary income. (§751(b)(1)(A)(ii))

³ For purposes of testing whether inventory is substantially appreciated, cash-basis receivables and ordinary income (§1245) depreciation recapture is considered in the computation. Due to this requirement that inventory be substantially appreciated in order to be treated as a "hot asset" in a redemption, it is more likely that a departing partner will recognize ordinary income in a cross-purchase than a redemption.

⁴ Sale of appreciated inventory and depreciation recapture cannot be reported on installment method (§453(i) and Rev. Rul. 89-108) While it is unclear if cash-basis receivables can be reported on the installment method, the general consensus among practitioners is that they cannot.

⁵ Treas. Reg. §1.1(h)-1(b)(3)(ii)

⁶ If the partnership has significant unrecaptured §1250 gain, it may be beneficial to the departing partner to have the buy-out structured as a redemption rather than a cross-purchase for this reason. Please note, however, that the remaining partners will pick up the burden of the remaining §1250 gain.

⁷ Treas. Reg. §1.736-1(b)(5)(ii) Note, an election is available to pro-rate the basis between annual payments under §1.736-1(b)(6). The ability to recover the entire basis first makes a redemption an attractive option, particularly when there is no substantially appreciated inventory.

⁸ Treas. Reg. 1.736-1(b)(7), Example 1

⁹ Treas. Reg. §1.736-1(a)(2)

ISSUES TO CONSIDER IN STRUCTURING A PARTNER BUY-OUT: SALE VERSUS REDEMPTION (cont'd)

IMPACT ON PARTNERSHIP		
When does the departing partner cease being a partner for tax purposes (and receiving a K-1)?	On the date of sale, even if payments are to be made in future years. Thus, if one partner in a two partner partnership sells their interest to the other partner, the partnership terminates <u>immediately</u> and becomes a SMLLC. ¹⁰	The partner remains a “partner” until the final payment is made. While they will not receive allocations of income or loss after the date of sale, they will receive a blank K-1. This will keep a two-partner partnership where one partner is redeemed intact until <u>all</u> payments have been made.
Is the disposition of the partnership interest treated as a “sale or exchange” that can cause a technical termination under §708?	Yes ¹¹	No ¹²
Can the purchase be structured so some of the payments are deductible by the buyer?	No	Yes. Under §736(a) some portion of redemption payments can be agreed upon between the partner and partnership to represent guaranteed payments, generating ordinary income to the partner and a deduction to the partnership. Generally the IRS will respect the allocations assigned to the redemption between the partner and the partnership, as long as reasonable value is assigned to the partner’s interest in the partnership. Also, for a general partner in a partnership in which capital is not a material producing factor, payments for the partner’s share of goodwill and unrealized receivables may also be treated as guaranteed payments, deductible by the partnership and ordinary income to the departing partner. ¹³

IMPACT ON BUYER		
When is the buyer entitled to a step-up under §743, §734 or §751?	In year 1, regardless of when payments are made. ^{14 15}	The partnership steps-up its assets as gain or ordinary income is recognized by the departing partner. ^{16 17}

¹⁰ Revenue Ruling 99-6

¹¹ §708(b)(1)(B)

¹² Treas. Reg. §1.708-1(b)(2)

¹³ §736(b)(3)(B) In general, the scope of §736(a) is beyond this table. There is also uncertainty as to whether an LLC member can be considered a “general partner.”

¹⁴ §743

¹⁵ A valid §754 election must be in place.

¹⁶ §734

¹⁷ Please note, the step-up inside the partnership on a redemption related to the “hot asset” ordinary income recognized by the departing partner is not dependent on a §754 election being in place. The step-up related to the capital gain recognized by the departing partner, however, is dependent on a valid §754 election being in place. The delayed step-up in a redemption including deferred payments will likely not be appealing to the remaining partners.

ISSUES TO CONSIDER IN STRUCTURING A SHAREHOLDER BUY-OUT IN AN S CORPORATION: SALE VERSUS REDEMPTION

ABC, Inc. is an S corporation owned equally by individuals A, B, and C. C wishes to retire from the S Corporation. Should he sell his shares equally to A and B or should the S corporation redeem C's interest? The following table discusses issues to consider when advising our clients on the proper way to structure such a transaction. (Disclaimer: this table anticipates a sale or redemption at FMV on terms that would be agreeable to a willing buyer and willing seller.)

ISSUE TO CONSIDER	SALE	REDEMPTION QUALIFYING FOR "SALE OR EXCHANGE" TREATMENT ¹	REDEMPTION NOT QUALIFYING FOR "SALE OR EXCHANGE TREATMENT"
Governing Code Section(s)	§1001	§302	§1368

IMPACT ON DEPARTING SHAREHOLDER			
What is the tax treatment to the departing shareholder?	Capital gain or loss on the difference between the selling price and the shareholder's basis in the S corporation stock.	Same as for a sale. Capital gain or loss. However, if the shareholder owned more than 5% of the value of the stock of the corporation prior to the redemption, §267(a)(1) will disallow any loss recognized by the shareholder.	Taxed under the normal S corporation distribution rules. Generally, for an S corporation with no AEP, distributions are a tax-free return of basis, followed by capital gain. For an S corporation with AEP, distributions follow the rules above to the extent of AAA, and then are taxed as a dividend to the extent of AEP. ^{2,3}
Does the shareholder receive an offset for their stock basis in computing income/gain?	Yes	Yes	No ⁴
Can the departing shareholder use the installment method to report any gain?	Yes ⁵	Yes ⁶	No. Since there is no sale or exchange, installment treatment is not permitted. Distribution of installment note in redemption would be taxed in the year of redemption. ⁷
What is the impact on the departing shareholder's losses suspended due to lack of basis?	Cannot be used to reduce gain or increase loss on sale of stock. They disappear. ⁸	Cannot be used to reduce gain or increase loss on sale of stock. They disappear. ⁹	Cannot be used to reduce gain or increase loss on sale of stock. They disappear.

¹ A redemption of a corporate shareholder's stock is treated as a dividend unless one of the tests of §302 can be met qualifying the redemption for sale or exchange treatment. In general, a redemption will be treated as a sale or exchange if it meets one of the following tests:

- a redemption of all of the stockholder's stock (§302(b)(3));
- a redemption which is "substantially disproportionate" (§302(b)(2)); or
- a redemption which is "not essentially equivalent to a dividend" (§302(b)(1)).

*please note, the attribution rules of §318 must be considered in meeting the §302 tests.

² §1368

³ It is important to note, because the general rules of S corporation distributions provide for a tax-free return of basis prior to recognizing capital gain, the only difference in sale or distribution treatment will result if the S corporation has AEP, potentially subjecting some of the redemption proceeds to dividend treatment.

⁴ Proposed regulations under §1.302-5 would prevent the departing shareholder from losing all the benefit of their basis in a complete redemption that is taxed as a dividend due to the attribution rules. These regulations are only proposed, however, and are not yet law.

⁵ §453

⁶ §453

⁷ PLR 8134027. Under Rev. Ruling. 89-122, the installment note should be valued at FMV for cash basis shareholders and face value for accrual basis shareholders.

⁸ Treas. Reg. §1.1366-2(a)(5)

⁹ Treas. Reg. §1.1366-2(a)(5)

ISSUES TO CONSIDER IN STRUCTURING A SHAREHOLDER BUYOUT IN AN S CORPORATION: SALE VERSUS REDEMPTION (cont'd)

IMPACT ON S CORPORATION			
What is the impact on the S corporation's AAA?	No impact. ¹⁰	AAA must be reduced by the pro-rata amount of stock redeemed (measured in shares, not value). ^{11 12}	AAA reduced under the general ordering rules for distributions under §1368. ¹³
What is the impact on the S corporation's AEP?	No impact	AEP must be reduced by the amount of cash distributed, limited to the pro-rata amount of stock redeemed (measured in shares, not value). ¹⁴	AEP reduced under the general ordering rules for distributions under §1368.
Is the S corporation entitled to a deduction or step-up?	No	No	No
Is any income/gain recognized by the corporation?	No	Only if the S corporation pays for the redeemed shares with appreciated property. ¹⁵	Only if the S corporation pays for the redeemed shares with appreciated property. ¹⁶
What is the effect on the S election?	None unless shares are sold to an ineligible shareholder.	None	In general, none. But may need to consider second class of stock issues if redemption rights are not the same for each shareholder. ¹⁷

IMPACT ON REMAINING STAKEHOLDERS			
What is the impact on the remaining shareholder's basis in the S corporation?	Creates tax basis equal to the cost of the purchased shares. ¹⁸	No impact.	No impact.
What other impact is there on the remaining shareholders?	Does not impact corporate level AAA or AEP.	Reduces AAA and AEP at corporate level (see above).	May reduce both AAA and AEP at corporate level.

¹⁰ Planning note: structuring the acquisition as a cross purchase preserves AAA, but also AEP, for the remaining shareholders.

¹¹ §1368(e)(1)(B)

¹² Ex: if 80 of 100 shares are redeemed, AAA is reduced by 80%.

¹³ Revenue Ruling 95-14

¹⁴ §312(n)(7)

¹⁵ §311(b)

¹⁶ §311(b)

¹⁷ §1361(b)(1)(D)

¹⁸ Please note, if the remaining shareholder's funds used to purchase the interest are provided through corporate distributions, the net impact on the remaining shareholder's stock basis may be zero (decrease for distributions from S corp./increase for purchased stock basis from departing shareholder).

ISSUES TO CONSIDER IN STRUCTURING A SHAREHOLDER BUY-OUT IN A C CORPORATION: SALE VERSUS REDEMPTION

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ISSUE TO CONSIDER	SALE	REDEMPTION QUALIFYING FOR "SALE OR EXCHANGE" TREATMENT ¹	REDEMPTION NOT QUALIFYING FOR "SALE OR EXCHANGE TREATMENT"
Governing Code Section(s)	§1001	§302	§301

IMPACT ON DEPARTING SHAREHOLDER			
What is the tax treatment of the departing shareholder?	Capital gain or loss on the difference between the selling price and the shareholder's basis in the corporation stock.	Same as for a sale. Capital gain or loss. However, if the shareholder owned more than 5% of the value of the stock of the corporation prior to the redemption, §267(a)(1) will disallow any loss recognized by the shareholder.	Taxed as a dividend to extent of corporate E&P. Excess is return of capital, then capital gain. ^{2,3}
Does the shareholder receive an offset for their stock basis in computing income/gain?	Yes	Yes	No ⁴
Can the departing shareholder use the installment method to report any gain?	Yes ⁵	Yes ⁶	No. The note must be valued as of the date of redemption and taxed under the dividend ordering rules of §301. ⁷

¹ A redemption of a corporate shareholder's stock is treated as a dividend unless one of the tests of §302 can be met qualifying the redemption for sale or exchange treatment. In general, a redemption will be treated as a sale or exchange if it meets one of the following tests:

- a redemption of all of the stockholder's stock (§302(b)(3));
- a redemption which is "substantially disproportionate" (§302(b)(2)); or
- a redemption which is "not essentially equivalent to a dividend" (§302(b)(1)).

*please note, the attribution rules of §318 must be considered in meeting the §302 tests.

² §301(c)

³ It is important to note, because the general rules of S corporation distributions provide for a tax free return of basis prior to recognizing capital gain, the only difference in sale or distribution treatment will result if the S corporation has AEP, potentially subjecting some of the redemption proceeds to dividend treatment.

⁴ This is commonly referred to as the problem of "disappearing basis." If a shareholder is fully redeemed, yet the redemption is treated as a dividend due to the attribution rules, the partner's basis is transferred to the other, related shareholder, and "disappears" from the redeemed shareholder.

⁵ §453

⁶ §453

⁷ PLR 8134027 Under Rev. Ruling 89-122, the installment note should be valued at FMV for cash basis shareholders and face value for accrual basis shareholders.

ISSUES TO CONSIDER IN STRUCTURING A SHAREHOLDER BUYOUT IN A C CORPORATION: SALE VERSUS REDEMPTION (cont'd)

IMPACT ON CORPORATION			
What is the impact on the corporation's E&P?	No impact.	E&P must be reduced by the amount of cash or note, but limited to the pro-rata amount of stock redeemed (measured in shares, not value). ⁸	E&P must be reduced by the amount of cash or principal amount of note. ⁹
Is any income/gain recognized by the corporation?	No	Only if the corporation pays for the redeemed shares with appreciated property. ¹⁰	Only if the corporation pays for the redeemed shares with appreciated property. ¹¹

IMPACT ON REMAINING SHAREHOLDERS			
What is the impact on the remaining shareholder's basis in the corporation?	Creates tax basis equal to the cost of the purchased shares.	No impact.	No impact.
What other impact is there on the remaining shareholders?	Does not impact corporate level E&P.	Reduces E&P at corporate level (see above).	May reduce E&P at corporate level.

⁸ §312(n)(7) Ex: if 80 of 100 shares are redeemed, E&P reduction is limited to 80%.

⁹ §312

¹⁰ §311(b)

¹¹ §311(b)