



Taxation of Pass-through Entities

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This Note discusses the US federal income tax rules that apply to US pass-through entities (that is, partnerships, multiple-member LLCs, S-corporations and, to some extent, REITs and RICs).

This Note discusses the US federal income tax rules that apply to US pass-through entities. Generally, pass-through entities include:

- General partnerships (GPs).
- Limited partnerships (LPs).
- Limited liability companies (LLCs).
- S-corporations.
- To some extent, real estate investment trusts (REITs) and regulated investment companies (RICs).

A GP, LP or multiple-member LLC is treated as a partnership for tax purposes unless it makes a tax election to be treated as a C-corporation. In this Note, GPs, LPs, and LLCs are referred to collectively as entities taxable partnerships and owners of these entities are referred to as partners. This Note focuses on entities taxable as partnerships, differentiating S-corporations, REITs and RICs as appropriate.

Generally, partnerships and S-corporations are not taxed at the entity level. Instead, the entity's profits and losses pass-through to the owners who include their respective share of those items on their individual income tax returns (whether or not distributed). REITs and RICs can also avoid (or minimize) an entity level

tax (see *General Taxability and Tax Reporting*). By contrast, C-corporations (the most common corporate form) generally are subject to two levels of tax on their income:

- At the entity level when earned.
- At the stockholder level when distributed.

For more information about the taxation of US business entities, see *Practice Note, Choice of Entity: Tax Issues* (<http://us.practicallaw.com/1-382-9949>).

The taxation of pass-through entities and their owners typically involve considerations during one of the following stages:

- At formation.
- During operations.
- On a transfer of assets (including the distribution of property from an entity to an owner).
- On a transfer of an ownership interest.

TAX ISSUES ON FORMATION

The key considerations on formation generally are:

- Contributions of property versus contributions of services.
- Contributions of property subject to liabilities.
- The requirement of control immediately after a contribution.

CONTRIBUTIONS OF PROPERTY VERSUS CONTRIBUTIONS OF SERVICES

Contributions of property to a pass-through entity generally are not taxable (see *IRC § 721*). However, contributions of services often are taxable (see *IRC § 83*).

Contributions of Property

Property contributions in exchange for a partnership interest on and after formation generally do not result in the taxation of the partnership or the contributing partner. Property contributions on original formation by owners of S-corporations, REITs and RICs also generally qualify for tax-free treatment but subsequent contributions may not qualify (see *IRC § 351* and *Control Immediately After a Contribution*).

A pass-through entity acquires a basis in the contributed property equal to the basis of the contributed property in the hands of the contributing owner (generally referred to as a carryover basis) (see *IRC § 723* for partnerships and *IRC § 358* for S-corporations, REITs and RICs). The pass-through entity's basis is increased to the extent that the contributing owner recognizes gain on the contribution. A partnership's basis in its all of its assets (including contributed assets) is commonly referred to as inside basis.

A contributing partner's basis in its partnership interest is equal to the partner's basis in the contributed property (a carryover basis) (see *IRC § 722*). Unique to partnerships, partners include a ratable share of the liabilities of the partnership in the basis of their partnership interests (see *IRC § 752*). A partner's basis in its partnership interest is commonly referred to as outside basis.

By contrast, for a contribution to an S-corporation, REIT or RIC, the stockholder's basis in the acquired shares is not necessarily equal to its basis in the contributed property (see *IRC § 362*).

Rather, a stockholder's basis in the acquired shares is reduced:

- To the extent the contributing stockholder receives any property or money in the contribution transaction.
- By the amount of liabilities assumed by the S-corporation, REIT or RIC on the contribution of property subject to liabilities.

See *IRC* Section 357.

Contributions of Services

Although most property contributions are excluded from taxation, contributions of services in exchange for an ownership interest in a pass-through entity often are taxable. Uniquely, the question of whether a contribution of services to a partnership is taxed depends on the type of partnership interest the service provider receives.

Partnership interests can be divided into capital interests and profits interests. A capital interest is a partnership interest that gives the owner the right to a share of proceeds if the partnership assets were sold at their fair market value and the proceeds were distributed in a complete liquidation of the partnership. A profits interest is a partnership interest that gives the owner the right to receive a percentage of future profits (but not existing capital) from the partnership. Most commonly, a profits interest (sometimes called a "profits-only" interest or "mere profits" interest) is granted to a partner in exchange for a contribution of services.

In most cases, the contribution of services in exchange for a capital interest in a partnership is taxable to the partner acquiring the capital interest (see *IRC § 83* and *Treas. Reg. §*

1.721-1(b)(1)). The partner recognizes taxable income to the extent of the fair market value of the acquired capital interest. The partnership generally obtains a tax deduction equal to the income recognized by the partner.

There is an exception to this income recognition rule for the receipt of a properly structured profits interest in a partnership in exchange for contributed services (see *Rev. Proc. 93-27*). Instead of taxing the contributing partner when the profits interest is received, the partner is taxed on allocations of partnership profits to the extent realized in subsequent years. For more information about profits interests, see *Practice Note, Profits Interests* (<http://us.practicallaw.com/3-422-4189>).

There is no equivalent to profits interest in an S-corporation, REIT or RIC. Therefore, a contribution of services to these entities in exchange for an ownership interest generally is taxable (see *IRC § 351(d)(2)*).

There is symmetry between the taxability of the receipt of an ownership interest in a pass-through entity for a contribution of services and the availability of a tax deduction for the pass-through entity. To the extent the person contributing services is taxed, the pass-through entity is entitled to a deduction (see *Treas. Reg. § 1.83-6*). However, to the extent that a partner receives a non-taxable profits interest in exchange for contributed services, the partnership does not receive a deduction.

CONTRIBUTIONS OF PROPERTY SUBJECT TO LIABILITIES

One of the more substantial distinctions between the taxation of partnerships and other pass-through entities is the treatment of liabilities. The tax treatment of liabilities also depends on whether the liabilities are recourse or nonrecourse liabilities.

Recourse versus Nonrecourse Liabilities

A liability is nonrecourse to the extent that a creditor can only satisfy the claim from the value of assets encumbered by the claim (see *Treas. Reg. § 1.752-1(a)(2)*). A liability is recourse to the extent that someone is responsible for the payment or repayment of the obligation with assets other than those specifically encumbered by the claim (see *Treas. Reg. § 1.752-1(a)(2)*). For this purpose, recourse liabilities include claims for which a person:

- Is primarily liable.
- Provides a guaranty, an indemnity or a hold harmless agreement.
- Used other personal or business assets to collateralize the obligation.

Recourse liabilities also include loans made to a partnership by a partner.

Partnership Contributions of Property Subject to Liabilities

A contribution to a partnership of property subject to a liability generally does not result in the taxation of the partnership or the



contributing partner. As discussed above, a contributing partner's basis in its partnership interest (its outside basis) is equal to the partner's basis in the contributed property. However, in the case of a contribution of property subject to a liability:

- The amount of nonrecourse liabilities assumed by the partnership reduces the partner's outside basis.
- A share of the nonrecourse liability encumbering the contributed property as well as a ratable share of other nonrecourse liabilities of the partnership are allocated to the contributing partner increasing that partner's outside basis. This rule typically results in an allocation to the contributing partner of the portion of a nonrecourse liability encumbering the contributed property equal to the excess of the fair market value of the contributed property over the basis of the contributed property immediately before contribution (but limited to the amount of the liability). This is commonly referred to as the built-in gain on the contributed property
- In the case of recourse liabilities, the contributing partner remains primarily liable for the claims of the creditor even after the contribution. As a result, recourse liabilities are generally never completely assumed by the partnership. Recourse liabilities are always allocated to the partner or partners that are either liable for the loans or the partner or partners that are the creditors on the loans.

For example, assume that:

- Partner A contributes property with \$125 gross fair market value subject to a recourse liability of \$75.
- Partner A has a \$25 basis in the property immediately before contribution.
- Partner B contributes \$50 in cash.
- Partner A and partner B each become 50% partners in the newly formed partnership.

In this example, the partnership takes a \$25 carryover basis in the contributed property. Partner A's basis in the acquired partnership interest (its outside basis) is equal to \$25 because the \$25 carryover basis from the contributed property is:

- Decreased by the \$75 of recourse liabilities assumed by the partnership.
- Increased by \$75 of recourse liabilities allocated to the contributing partner.

Therefore, partner A recognizes no gain or loss on contribution even though the recourse liabilities assumed by the partnership (\$75) exceeded partner A's basis in the contributed property (\$25). Partner B takes a \$50 carryover basis in the acquired partnership interest (equal to the cash contribution). The same allocation results if the liability is nonrecourse because nonrecourse liabilities are allocated to the contributing partner equal to the built-in gain on the contributed property (\$75 in this example).

Alternatively, assume that the partner has an adjusted basis in the contributed asset of \$100 immediately before contribution and the liability is nonrecourse. In this example, the partnership

takes a \$100 carryover basis in the contributed property. Partner A's basis in the acquired partnership interest (its outside basis) is equal to \$75 because the \$100 carryover basis from the contributed property is:

- Decreased by the \$75 of nonrecourse liabilities assumed by the partnership.
- Increased by \$50 of nonrecourse liabilities allocated to the contributing partner, calculated as follows:
 - increased by the \$25 difference between the \$125 gross fair market of the contributed property and Partner A's \$100 basis in the contributed property immediately before contribution; and
 - increased by the \$25 ratable share of the remaining liability (\$50 of remaining liability times the 50% ownership percentage).

Partner B's basis in the acquired partnership interest is \$75 (the \$50 cash contributed plus a ratable (50%) allocation of remaining partnership liabilities (\$25 in this example)).

Different Rule for S-corporation, REIT or RIC

By contrast, a stockholder of an S-corporation, REIT or RIC that contributes property subject to a recourse or nonrecourse liability recognizes taxable gain on the contribution date to the extent the liability exceeds the stockholder's basis in the contributed property (see *IRC* § 357(c)). Any gain recognized by the stockholder increases its basis in the acquired stock. However, any liability assumed by the S-corporation, REIT or RIC is deemed to be cash or property received by the contributing stockholder, which reduces their basis in the acquired stock.

For example, assume a prospective S-corporation stockholder contributes property with a gross fair market value of \$125, a basis of \$25 and subject to a \$75 liability. The stockholder recognizes \$50 of gain on the contribution to the S-corporation (\$75 liability minus the \$25 basis in the contributed property). The stockholder's basis in the acquired stock is equal to \$0 (the \$25 original basis increased by the \$50 of recognized gain and decreased by the \$75 liability assumed by the S-corporation). The S-corporation acquires a basis in the contributed property equal to the basis of the property in the hands of the contributor plus the gain recognized by the contributor on contribution. In this example, the S-corporation has a \$75 basis in the contributed property (the \$25 original basis plus the \$50 of recognized gain).

CONTROL IMMEDIATELY AFTER A CONTRIBUTION

Stockholders of S-corporations, REITs and RICs must be in control of the entity immediately after a contribution to qualify for tax-free treatment (see *IRC* § 351). For this purpose, control means ownership of at least 80% of the voting stock of the corporation and at least 80% of all other stock of the corporation. While this requirement generally is met on the original formation of an S-corporation, REIT or RIC, contributions after formation often do not qualify (unless the contributing stockholder is in control of the corporation immediately after the post-formation contribution).

By contrast, there is no control requirement for tax-free contributions to partnerships either at the time of original formation or after formation (see *IRC § 721*). Therefore, it is much easier to structure tax-free contributions to a partnership.

TAXATION OF OPERATIONS

The key considerations in the taxation of operating results generally are:

- General taxability and tax reporting.
- Allocations of:
 - operating income among the owners;
 - operating losses among the owners; and
 - distributable cash flow.
- Compensation of owners and employment taxes.

GENERAL TAXABILITY AND TAX REPORTING

Partnerships (see *IRC § 701*) and S-corporations (see *IRC § 1363*) are not taxed separately on their operating results. This means that partnerships and S-corporations file informational returns reporting their operating earnings and losses which are allocated to their owners (the partners or stockholders). Partners (see *IRC § 702*) and S-corporation stockholders (see *IRC § 1366*) report their allocable share of the operating earnings or losses on their individual income tax returns, regardless of whether the earnings are distributed to the owners. Therefore, partners and S-corporation stockholders can have phantom income (meaning that the partner or stockholder has not received any cash but is still taxed).

REITs (see *IRC § 857*) and RICs (see *IRC § 856*) file tax returns claiming deductions for qualifying distributions made to their stockholders which reduce or eliminate the entity level tax. However, in some cases, REITs and RICs can pay an entity level tax. REIT and RIC stockholders only report distributions actually received on their tax returns as:

- Capital gains.
- Ordinary income.
- Non-taxable distributions of invested capital (to the extent that REIT and RIC distributions exceed the REIT's or RIC's current and accumulated earnings and profits). Although calculated with some notable adjustments, a REIT's or RIC's current and accumulated earnings and profits are consistent with the economic concept of an entity's retained earnings.

This means that REIT and RIC stockholders generally do not have a phantom income problem.

ALLOCATIONS OF TAXABLE INCOME

S-corporations are subject to a rigid scheme for allocating taxable income. Each share of stock receives a ratable share of taxable income for each day it is outstanding (referred to as the per-share-per-day rule) (see *IRC § 1377*). Absent an election to cut off the books and records of the S-corporation (see *IRC § 1377(a)(2)*),

the per-share-per-day rule does not take into account economic consequences of admitting stockholders into the S-corporation during the year or the occurrence of significant income or loss recognition transactions that may occur before or after any admission. Failure to properly consider an election to cut off the books and records is often a trap for the unwary.

The requirements for an effective election to cut off the books and records include:

- The complete termination of at least one stockholder's entire interest in the S-corporation.
- The consent of all affected stockholders. An affected stockholder includes:
 - both the buyer and the seller of S-corporation shares for transfers of shares between individuals; and
 - all other stockholders at the time of redemption for a complete redemption of stockholder's interest.
- An affirmative declaration by the S-corporation (in its tax return for the taxable year which includes the terminated interest) of:
 - the election to cut off the books and records;
 - the information setting forth the facts concerning the termination of interest; and
 - a statement that all affected stockholders have consented.

See Treasury Regulation Section 1.1377-1(b)(5).

An electing S-corporation only files one tax return for the year. However, if it properly elects to cut off the books and records, the S corporation can allocate its operating results among the stockholders as if the taxable year closed on the termination of any stockholder's interest.

A stockholders agreement for an S-corporation should document that the making or failing to make this election has been considered by the stockholders. For example, a stockholders agreement may include the following language:

"The taxable year of the Company in which the interest of any Stockholder is terminated shall be treated for tax purposes as two or more separate taxable years (depending on the number of events of termination) pursuant to IRC Section 1377(a)(2). Each Stockholder shall execute and file all consents and other documents required by IRC Section 1377(a)(2) and the Treasury Regulations under that Section to effectuate the purposes of this Section. The Stockholder acknowledges that the adoption of this Stockholders Agreement shall constitute the consent referred to in the immediately preceding sentence."

Partnerships have much more flexibility in allocating taxable income. However, this flexibility results in a fair amount of complexity. Generally, partnerships can divide the economic interests of the partnership in any fashion agreed to by the partners so long as the related allocations have "substantial economic effect" (see *IRC § 704* and the accompanying Treasury Regulations). An allocation has substantial economic effect if:

- Items of taxable income, gain, loss and deduction are allocated to partners in the same manner that distributable cash or property on liquidation is allocated to the partners.
- The partnership maintains capital accounts on behalf of each partner for this purpose.
- The allocations generally affect the amounts received by partners without regard to tax consequences.

For example, allocating taxable income to tax-exempt partners and taxable losses only to taxable partners, while allocating distributable cash flow in accordance with ownership percentages, generally would not make economic sense for the partners except for on an after-tax basis. Therefore, these allocations generally would not have substantial economic effect.

ALLOCATIONS OF OPERATING LOSSES

The most significant reason for choosing to operate a business as a partnership (other than avoiding double taxation) is that partners can deduct business losses on their individual income tax returns.

Partnerships allocate losses in accordance with the risk of loss rules (see *Treas. Reg. §1.704-2(b)*). Generally, risk of loss reflects the priority that any one party has over another for distributable proceeds (the lower the priority, the higher the risk of loss). Third-party creditors generally have priority over partner creditors, and all creditors have priority over equity owners. The following are the ordering rules applicable to risk of loss allocations:

- First, losses are allocated in accordance with percentage interests in the partnership to the extent that the partners have positive capital accounts.
- Second, losses are allocated among only those partners with positive capital accounts.
- Third, once all capital accounts have been reduced to zero, losses are allocated to partners for their recourse indebtedness of the partnership.
- Finally, remaining losses are allocated among partners according to each partner's percentage interest in the partnership.

Allocated losses are subject to several other limitations:

- Losses are nondeductible to the extent they exceed the partners' basis in the partnership (see *IRC § 704(d)*).
- At risk limitations (see *IRC §465*).
- Passive loss limitations (see *IRC §469*).

At risk limitations prevent a partner from deducting losses in excess of their amount at risk in an activity. Generally, amounts at risk include:

- Capital contributed to the activity.
- Income previously allocated to the investor from the activity.
- Borrowed amounts contributed or otherwise advanced to the activity to the extent the borrowed amounts are not collateralized by any property used in the activity (meaning, recourse debt).

There is an exception for nonrecourse debt collateralized by real estate to the extent the amounts are borrowed from qualified lenders (meaning, banks and similar financial institutions).

Passive loss limitations prevent a partner from deducting losses in excess of their passive income. Passive losses are generated in an activity where the taxpayer is not active in the operation of the business activity (meaning, a passive investor). Rental activities are deemed per se passive. Losses are deductible to the extent of passive income from all passive activities or to the extent the entire activity is disposed of.

Different Rule for S-corporation, REIT or RIC

S-corporations do not have ordering rules regarding loss allocations. Losses are allocated in accordance with per-share-per-day rule. Generally, S-corporation stockholders cannot include the liabilities of the S-corporation in the basis of their shares.

Losses that exceed basis are suspended until there is income from the S-corporation (see *IRC §1366(d)(2)*). There is an exception for loans made by a stockholder to the S-corporation. However, to qualify for this exception the loan must be funded with cash (see *IRC §1366(d)(1)(b)*). Stockholder guaranties and other credit enhancements of S-corporation indebtedness do not qualify.

Unlike partnerships and S-corporations, operating losses of REITs and RICs do not pass-through to their owners. Instead, REIT and RIC losses can result in non-taxable distributions to REIT and RIC stockholders to the extent that REIT and RIC distributions exceed the REIT's or RIC's current and accumulated earnings and profits (see *IRC §§ 302 and 312 and General Taxability and Tax Reporting*).

ALLOCATIONS OF DISTRIBUTABLE CASH FLOW

As described above, REIT and RIC stockholders report any distributions actually received on their tax returns as:

- Capital gains.
- Ordinary income.
- Non-taxable distributions of invested capital (to the extent that any distributions exceed the REIT's or RIC's current and accumulated earnings and profits).

REITs and RICs are permitted a deduction in arriving at taxable income for qualifying distributions to their stockholders which can reduce or eliminate the entity level tax (see *General Taxability and Tax Reporting*).

For partnerships and S-corporations, the partners and stockholders typically do not recognize taxable income on the receipt of operating cash flow except to the extent that the distributions exceed the owners' outside basis in the entity. As with allocations of taxable income:

- Partnerships must make distributions to members in accordance with the substantial economic effect rules.
- S-corporations must distribute cash in accordance with the per-share-per-day rule.

See *Allocations of Taxable Income*.

COMPENSATION OF OWNERS AND EMPLOYMENT TAXES

S-corporations and partnerships typically have employees. However, while S-corporation stockholders can also serve as employees of the S-corporation, partners are not recognized as employees of the partnership for tax purposes (see *Rev. Rul. 69-184*). Instead, compensation paid to partners is classified as a guaranteed payment to the extent that:

- Partners provide services to the partnership.
- The services are provided in their capacity as partners.
- The amounts received are not dependent on partnership profits.

Guaranteed payments are functionally similar to wages:

- The partnership receives a deduction for the amount of the guaranteed payment.
- The recipient includes the amount of the guaranteed payment in taxable income.

However, unlike wages, guaranteed payments are not subject to employment or income withholding taxes (see *IRC § 707(c)*). Instead, they are subject to self-employment tax assessed on the partner. In addition, guaranteed payments are included in taxable income by the recipient in the year deducted by the partnership. For example, if a calendar year partnership properly accrues a guaranteed payment in 2010 to a partner that is not paid until 2011, the partner must include the accrued guaranteed payment in income in the same calendar year that the partnership accrues the deduction (2010 in this case).

Liability for employment taxes is one of the key differences in the tax rules that apply to partnerships and S-corporations:

- A partner generally includes all trade or business income of a partnership (including the amounts characterized as guaranteed payments) in self-employment income which is subject to social security and medicare taxes (see *IRC § 1402(a)*).
- An S-corporation stockholder's exposure for employment taxes is limited to the salary paid to the stockholder by the S-corporation. This often results in substantial employment tax savings for the owners of an S-corporation.

TAXATION OF ASSET TRANSFERS

The key considerations in the taxation of asset transfers generally are:

- The entity level taxation of asset sales.
- The allocation of gains and losses among owners on an asset sale.
- The taxation of asset distributions.

ENTITY LEVEL TAXATION OF ASSET SALES

When a C-corporation elects S-corporation status to obtain relief from double taxation, there remains the potential for an entity level tax on a later asset transfer. If a C-corporation has appreciated assets (assets with a fair market value greater than their basis) on the date of conversion to an S-corporation, the sale of assets by the S-corporation within a specified recognition period after

the S-corporation election can generate an entity level tax as well as taxable income for the stockholders (referred to as the built-in gain or BIG tax, see *IRC § 1374*). The specified recognition period is ten years but is temporarily reduced to seven years for taxable years beginning in 2009 and 2010 and to five years for taxable years beginning in 2011 (note that the recognition period will revert to ten years for taxable years beginning in 2012). The BIG tax only applies to S-corporations that sell assets which were appreciated assets at the time that a C-corporation converted to an S-corporation and only to the extent of the appreciation that existed on the date of conversion.

The BIG tax does not apply if the S-corporation:

- Has been an S-corporation since formation (even if formed with appreciated assets).
- Did not have appreciated assets when it converted from a C-corporation to an S-corporation.
- Waits until the expiration of the specified recognition period to dispose of built-in gain assets.

There is no corresponding entity level tax applicable to asset sales by partnerships. However, partnerships are required to allocate the built-in gain or loss (the difference between the fair market value of contributed property and the contributing partner's basis in the contributed asset) solely to the contributing partner as described more fully below (see *Allocations of Taxable Gain and Loss in Asset Sales*).

ALLOCATIONS OF TAXABLE GAIN AND LOSS IN ASSET SALES

If a partnership or S-corporation uses funds borrowed from a third party (any person that is not a partner or stockholder) or cash contributed by its partners or stockholders to acquire assets, the resulting gain or loss from a sale of the acquired assets generally is allocated to partners or stockholders in accordance with the general rules for allocating taxable income:

- Partnerships allocate the gain or loss in the manner that liquidation proceeds are distributed.
- S-corporations allocate these items based on the per-share-per-day rule and cannot specially allocate gains or losses.

See *Allocations of Taxable Income*.

However, on the sale of property contributed to a partnership by one of its partners, a portion of the resulting gain or loss recognized for tax purposes (up to the amount of the built-in gain or loss attributable to the property on the contribution date) is allocated entirely to the contributing partner (see *IRC § 704(c)*). However, any change in the built-in gain or loss after the contribution date is shared among all of the partners. In addition, if built-in gain property is distributed to a partner other than the contributing partner within five years of the original contribution date, the built-in gain is recognized by the partnership and allocated entirely to the contributing partner.

S-corporations are not subject to these special rules. Even for contributions by stockholders of appreciated or depreciated



property, the per-share-per-day rule applies and each stockholder is allocated a share of all items of income, deduction, gain or loss. For example, if at the time of formation:

- Stockholder A contributes property with a fair market value of \$200 and a basis of \$140 in exchange for a 50% interest in an S-corporation.
- Stockholder B contributes \$200 of cash for the other 50% interest.
- The S-corporation sells the contributed property at the same fair market value at its date of contribution (\$200) and has no other items of income, deduction, gain or loss or cash flow during the year.

Then, as a result of this sale:

- Stockholders A and B each recognize \$30 of income from the sale of the contributed asset.
- Stockholder A has effectively shifted half of the tax burden of the contributed property onto stockholder B until its shares are sold or liquidated.

REIT (see *IRC § 857(b)*) and RIC (see *IRC § 852(b)*) distributions attributable to sales of capital gain assets by the REIT and RIC can be characterized as distributions of capital gain income so that the REIT and RIC distributions are taxable to their stockholders at the more favorable capital gain rates. Distributions designated as capital gain distributions are treated as income from the sale of a capital asset held for more than a year. As a result, these distributions can be offset with capital losses.

TAXATION OF ASSET DISTRIBUTIONS

Generally, when an S-corporation distributes appreciated assets to its stockholders, gain is recognized by the stockholders on the transaction (see *IRC § 311(b)*).

Unlike S-corporations, the general rule for partnerships is that the distribution of property (whether appreciated or depreciated in value) does not result in the recognition of taxable income or loss for a partner receiving the property distribution. Instead, the partner takes a carryover basis in the distributed property (preserving the gain for later recognition on a taxable disposition of the property).

As described above, partners include a ratable share of the partnership's liabilities in their outside basis (see *Contributions of Property Subject to Liabilities*). The distribution of property subject to a liability potentially causes all partners to adjust their outside basis. For partners not receiving a distribution, their outside basis is reduced by their ratable share of the liabilities (if any) encumbering the distributed property. For the partner receiving the encumbered property, that partner must:

- Decrease their outside basis by the share of liabilities they are deemed relieved of (including the liabilities encumbering the distributed property).
- Increase their outside basis by the share of liabilities assumed on the distributed property.

For example, assume a partner has a negative capital account of \$300 in a partnership that has several assets subject to nonrecourse liabilities and the partner is allocated \$500 of the partnership liabilities. Therefore, the partner has an outside basis of \$200. Assume the partner's interest in the partnership is worth \$400. If the partner is redeemed out of the partnership for property with a net fair market value of \$400 (gross fair market value \$1,000 but subject to a nonrecourse liability of \$600), the partner's outside basis of \$200 is:

- Decreased by the \$500 of liabilities relieved.
- Increased by the \$600 of liabilities assumed.

Therefore, the partner's outside basis is adjusted to \$300 and the partner acquires a \$300 carryover basis in the distributed property (which is equal to the partner's outside basis). No gain or loss is recognized by the partnership or the liquidated partner.

Alternatively, if the partner received property with a net fair market value of \$400 (gross fair market value \$600 but subject to a nonrecourse liability of \$200), the partner's outside basis of \$200 is:

- Decreased by the \$500 of liabilities relieved.
- Increased by the \$200 of liabilities assumed.

Therefore, the partner's outside basis is negative \$100. So, the partner would be deemed to have received \$100 of money in excess of their outside basis. In this case, the \$100 is taxable to the partner and the partner takes a \$0 basis in the distributed property.

In both examples, each of the remaining partners adjusts its basis in its partnership interest for the liabilities assumed by the redeemed partner.

TAXATION OF DISPOSITIONS OF OWNERSHIP INTERESTS

The key considerations in the taxation of dispositions of ownership interests generally are:

- Character of income from a disposition.
- Adjustment to the basis of assets from a disposition.
- Deemed termination of a partnership for tax purposes.

CHARACTER OF INCOME

The gain or loss resulting from a taxable disposition of an interest in a partnership, S-corporation, REIT or a RIC is generally a capital gain or loss for the selling partner or stockholder. The taxable gain or loss is equal to the difference between the proceeds received and the partner's or stockholder's basis in its partnership interest or shares.

For dispositions of partnership interests, there are a set of recharacterization rules referred to as "hot asset" sale rules (see *IRC § 751*). Hot asset sales involve the disposition of a partnership interest if the partnership owns any of the following:

- Appreciated inventory.
- Accounts receivable that have not been recognized in taxable income (meaning, the partnership has uncollected receivables and reports its taxable income on the cash basis).
- Other recapture items (such as appreciation on previously depreciated personal property).

The hot asset sale rules recharacterize all or a portion of gain that would otherwise be capital gain into ordinary income. For example, assume a partnership:

- Has uncollected accounts receivable at year end of \$180 which is the partnership's only asset.
- Is owned equally by three persons.
- Has no liabilities.
- Has distributed all of its cash earnings to its owners.

One partner sells its entire partnership interest to a new partner for \$60 when its outside basis is \$0. As a result of the sale:

- The entire \$60 of proceeds is taxable (\$60 of sale proceeds less a \$0 basis).
- The hot asset sale rules recharacterize the entire \$60 gain as ordinary income.

These hot asset sale rules can also result in the recognition of taxable income as part of a transaction that is otherwise intended to be tax-free. While these rules are complex and often pose traps for the unwary, their purpose is to prevent partners from avoiding ordinary income recognition on assets like uncollected receivables on dispositions of their partnership interests.

There are no hot asset sale rules for S-corporations, REITs or RICs. If the entity in the example above is an S-corporation, the entire gain recognized by the transferor stockholder is taxable as capital gain.

ADJUSTMENTS TO THE BASIS OF ASSETS

The transfer of a partnership interest can also result in an adjustment to the basis of the partnership assets. This basis adjustment is unique to entities taxable as partnerships. Generally, S-corporations, REITs and RICs are not permitted to adjust the basis of their assets on transfers of equity interests. There is a limited exception for Section 338(g) and Section 338(h)(10) elections but these elections generally:

- Generate an entity level tax.
- Are beneficial in only limited circumstances.

For more information on Section 338 elections, see *Practice Note, Stock Acquisitions: Tax Overview: Stock Acquisitions Treated as Asset Acquisitions* (<http://us.practicallaw.com/9-383-6719>).

The adjustment to the basis of the assets held by a partnership occurs on the transfer of interests if the partnership properly elected to make basis adjustments (referred to as a Section 754 election). The basis adjustment:

- May increase or decrease the basis of the partnership assets.

- Is allocated among the assets in proportion to their relative fair market values.

Section 754 adjustments are generally allocated to the partner that acquires a partnership interest from another partner. In the case of step-up adjustments to depreciable property, the step-up increases depreciation adjustments to the transferee partner. Section 754 adjustments can also result from the redemption of partnership interests. In these cases, all of the partners share in the adjustment to the inside basis of assets. A Section 754 election can result in a step-down as well as a step-up of the inside basis of assets. Once a Section 754 election is made, it is generally irrevocable.

The primary tax advantage of a Section 754 election is that the excess (if any) of a partner's outside basis in their partnership interest over their share of the inside basis of partnership assets can be recovered (either through increased depreciation deductions or reduced gains or increased losses) to offset their share of taxable income from the partnership.

For example, assume facts similar to the example above regarding hot assets (see *Character of Income*). A partnership:

- Has uncollected accounts receivable at year end of \$180 which is the partnership's only asset.
- Has a \$0 basis in the uncollected receivable.
- Is owned equally by three persons.
- Has no liabilities.
- Has distributed all of its cash earnings to its owners.
- Has a Section 754 election in place to adjust the basis of its assets.

One partner sells its entire partnership interest to a new partner for \$60 when its outside basis is \$0. As a result of the sale:

- The partner disposing of its one-third interest has \$60 of taxable ordinary income under the hot asset sale rules.
- The partnership adjusts a portion of the basis of its assets (the receivable) by \$60 (the fair market value of the partnership interest transferred to the new partner (\$60 or one-third of \$180) minus the transferor partner's \$0 share of the inside basis of the partnership assets).
- The new partner is allocated the entire \$60 basis adjustment from the Section 754 election. This results in a deduction of \$60 for the new partner at the time of the collection of the receivable.
- The partnership collects the \$180 on the receivable and allocates \$60 of taxable ordinary income to each partner, including the new partner.
- The new partner recognizes no taxable income on the collection of the receivable (\$60 of income from collection of the receivable minus \$60 deduction from the Section 754 election).

By contrast, if the entity in the example above is an S-corporation:

- The transfer of the S-corporation shares does not result in a basis adjustment.



- The stockholder disposing of its one-third interest has \$60 of taxable capital gain. In the partnership context, the partner disposing of its interest has \$60 of taxable ordinary income.
- The S-corporation collects the \$180 and allocates \$60 of taxable ordinary income to each stockholder, including the new stockholder.
- The new stockholder has \$60 of taxable ordinary income upon the collection of the receivable. In the partnership context, the new partner had no taxable income on the collection of the receivable because of the Section 754 election.

DEEMED TERMINATION OF THE PARTNERSHIP

Another result unique to entities taxable as a partnership is the potential for a deemed termination of the partnership for tax purposes after a disposition. On the transfer of more than 50% of the interests in a partnership within a 12-month period, the partnership terminates for tax purposes (see *IRC §708*). The partnership is deemed to have liquidated and reformed itself for tax purposes.

While partnerships generally can form and liquidate on a tax-free basis, deemed terminations can result in:

- The restart of cost-recovery periods for depreciable property.
- Hot asset sale considerations.
- Unintended basis reductions from adjustments to the basis of assets from the deemed transfer of interests.
- Other unintended state tax ramifications.

Deemed terminations are mechanical and mandatory, not elective. However, planning can avoid undesired terminations (for example, spanning two 30% interest transfers more than 12 months apart). These terminations are for tax purposes only and have no impact under state partnership or limited liability company law.

There is no corresponding deemed termination rule for S-corporations, RICs and REITs. S-corporations, RICs and REITs do not even terminate on the transfer of 100% of their ownership interests. However, an S-corporation, RIC or REIT converts to a C-corporation for tax purposes if it fails to meet the requirements for an S-corporation, RIC or REIT. This conversion generally has tax consequences.

S-corporations can also be formed or remain in existence even if there is only one stockholder. Entities taxable as partnerships cease to be taxable as partnerships when there is only one partner remaining. Instead, the partnership converts to a disregarded entity for tax purposes and this conversion generally has tax consequences for the original partners (see *Treas. Reg. § 301.7701-3(f)(2)* and *Rev. Rul. 99-6*).

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