

IRS RULES ON TERMINATION OF LLC'S PARTNERSHIP STATUS.

JAN. 14, 1999

Citations: Rev. Rul. 99-6; 1999-1 C.B. 432

SUMMARY BY TAX ANALYSTS

The Service in Revenue Ruling 99-6 has addressed the tax consequences arising when one person buys all of the ownership interests in a limited liability company that's classified as a partnership, causing the LLC's status as a partnership to terminate.

The ruling considers two fact situations. In each situation an LLC is formed and operates in a state that permits an LLC to have a single owner. Each LLC is classified as a partnership under reg. section 301.7701-3.

In Situation 1, two individuals (we'll call them Ann and Bill) are equal partners in AB, an LLC. Ann sells her entire interest in AB to Bill for \$10,000. After the sale, the business is continued by the LLC, which is owned solely by Bill.

In Situation 2, Chuck and Dawn are equal partners in CD, an LLC. Chuck and Dawn sell their entire interests in CD to Ed, an unrelated person, in exchange for \$10,000 each. After the sale, the business is continued by the LLC, which is owned solely by Ed.

In both situations, after the sale, no entity classification election is made under reg. section 301.7701-3(c) to treat the LLC as an association for federal tax purposes.

In Situation 1, the Service ruled, the AB partnership terminates under section 708(b)(1)(A) when Bill buys Ann's interest. Consequently, Ann has to treat the transaction as the sale of a partnership interest. She must report gain or loss, if any, resulting from the sale of her partnership interest in accordance with section 741.

For purposes of determining Bill's tax treatment, the IRS said, the partnership is deemed to make a liquidating distribution of all its assets to Ann and Bill, and following the distribution Bill is treated as acquiring the assets deemed to have been distributed to Ann in liquidation of her partnership interest. The Service cited *Edwin E. McCauslen v. Commissioner*, 45 T.C. 588 (1966), and Rev. Rul. 67-65, 1967-1 C.B. 168, as support for that conclusion.

The Service further ruled that Bill's basis in the assets attributable to Ann's one-half interest in the partnership is \$10,000. Section 735(b), the IRS said, doesn't apply regarding the assets Bill is deemed to have purchased from Ann. Therefore, Bill's holding period for those assets begins on the day after the date of the sale.

On the termination of AB, the Service ruled, Bill is considered to receive a distribution of those assets attributable to his former interest in AB. He must recognize gain or loss, if any, on the deemed distribution of the assets to the extent required by section 731(a). Bill's basis in the assets received in the deemed liquidation of his partnership interest is determined under section 732(b). Under section 735(b), the IRS said,

Bill's holding period for the assets attributable to his one-half interest in AB includes the partnership's holding period for those assets (except for purposes of section 735(a)(2)).

Regarding Situation 2, the Service ruled that the CD partnership terminates under section 708(b)(1)(A) when Ed buys the interests of Chuck and Dawn. Chuck and Dawn must report gain or loss, if any, resulting from the sale of their partnership interests in accordance with section 741.

For purposes of classifying Ed's acquisition, the IRS said, the CD partnership is deemed to make a liquidating distribution of its assets to Chuck and Dawn. Immediately following that distribution, Ed is deemed to acquire, by purchase, all of the former partnership's assets.

Finally, the Service ruled, Ed's basis in the assets is \$20,000 under section 1012. His holding period for the assets begins on the day immediately following the date of sale.

Rev. Rul. 99-6

ISSUE

[1] What are the federal income tax consequences if one person purchases all of the ownership interests in a domestic limited liability company (LLC) that is classified as a partnership under section 301.7701-3 of the Procedure and Administration Regulations, causing the LLC's status as a partnership to terminate under section 708(b)(1)(A) of the Internal Revenue Code?

FACTS

[2] In each of the following situations, an LLC is formed and operates in a state which permits an LLC to have a single owner. Each LLC is classified as a partnership under section 301.7701-3. Neither of the LLCs holds any unrealized receivables or substantially appreciated inventory for purposes of section 751(b). For the sake of simplicity, it is assumed that neither LLC is liable for any indebtedness, nor are the assets of the LLCs subject to any indebtedness.

[3] Situation 1. A and B are equal partners in AB, an LLC. A sells A's entire interest in AB to B for \$10,000. After the sale, the business is continued by the LLC, which is owned solely by B.

[4] Situation 2. C and D are equal partners in CD, an LLC. C and D sell their entire interests in CD to E, an unrelated person, in exchange for \$10,000 each. After the sale, the business is continued by the LLC, which is owned solely by E.

[5] After the sale, in both situations, no entity classification election is made under section 301.7701-3(c) to treat the LLC as an association for federal tax purposes.

LAW

[6] Section 708(b)(1)(A) and section 1.708-1(b)(1) of the Income Tax Regulations provide that a partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

[7] Section 731(a)(1) provides that, in the case of a distribution by a partnership to a partner, gain is not recognized to the partner except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.

[8] Section 731(a)(2) provides that, in the case of a distribution by a partnership in liquidation of a partner's interest in a partnership where no property other than money, unrealized receivables (as defined in section 751(c)), and inventory (as defined in section 751(d)(2)) is distributed to the partner, loss is recognized to the extent of the excess of the adjusted basis of the partner's interest in the partnership over the sum of (A) any money distributed, and (B) the basis to the distributee, as determined under section 732, of any unrealized receivables and inventory.

[9] Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of the partner's interest in the partnership, reduced by any money distributed in the same transaction.

[10] Section 735(b) provides that, in determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of section 735(a)(2)), there shall be included the holding period of the partnership, as determined under section 1223, with respect to the property.

[11] Section 741 provides that gain or loss resulting from the sale or exchange of an interest in a partnership shall be recognized by the transferor partner, and that the gain or loss shall be considered as gain or loss from a capital asset, except as provided in section 751 (relating to unrealized receivables and inventory items).

[12] Section 1.741-1(b) provides that section 741 applies to the transferor partner in a two-person partnership when one partner sells a partnership interest to the other partner, and to all the members of a partnership when they sell their interests to one or more persons outside the partnership.

[13] Section 301.7701-2(c)(1) provides that, for federal tax purposes, the term "partnership" means a business entity (as the term is defined in section 301.7701-2(a)) that is not a corporation and that has at least two members.

[14] In *Edwin E. McCauslen v. Commissioner*, 45 T.C. 588 (1966), one partner in an equal, two-person partnership died, and his partnership interest was purchased from his estate by the remaining partner. The purchase caused a termination of the partnership under section 708(b)(1)(A). The Tax Court held that the surviving partner did not purchase the deceased partner's interest in the partnership, but that the surviving partner purchased the partnership assets attributable to the interest. As a result, the surviving partner was not permitted to succeed to the partnership's holding period with respect to these assets.

[15] Rev. Rul. 67-65, 1967-1 C.B. 168, also considered the purchase of a deceased partner's interest by the other partner in a two-person partnership. The Service ruled that, for the purpose of determining the purchaser's holding period in the assets attributable to the deceased partner's interest, the purchaser should treat the transaction as a purchase of the assets attributable to the interest. Accordingly, the purchaser was not permitted to succeed to the partnership's holding period with respect to these assets. See also Rev. Rul. 55-68, 1955-1 C.B. 372.

ANALYSIS AND HOLDINGS

[16] Situation 1. The AB partnership terminates under section 708(b)(1)(A) when B purchases A's entire interest in AB. Accordingly, A must treat the transaction as the sale of a partnership interest. Reg. section 1.741-1(b). A must report gain or loss, if any, resulting from the sale of A's partnership interest in accordance with section 741.

[17] Under the analysis of *McCauslen* and Rev. Rul. 67-65, for purposes of determining the tax treatment of B, the AB partnership is deemed to make a liquidating distribution of all of its assets to A and B, and following this distribution, B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A's partnership interest.

[18] B's basis in the assets attributable to A's one-half interest in the partnership is \$10,000, the purchase price for A's partnership interest. Section 1012. Section 735(b) does not apply with respect to the assets B is deemed to have purchased from A. Therefore, B's holding period for these assets begins on the day immediately following the date of the sale. See Rev. Rul. 66-7, 1966- 1 C.B. 188, which provides that the holding period of an asset is computed by excluding the date on which the asset is acquired.

[19] Upon the termination of AB, B is considered to receive a distribution of those assets attributable to B's former interest in AB. B must recognize gain or loss, if any, on the deemed distribution of the assets to the extent required by section 731(a). B's basis in the assets received in the deemed liquidation of B's partnership interest is determined under section 732(b). Under section 735(b), B's holding period for the assets attributable to B's one-half interest in AB includes the partnership's holding period for such assets (except for purposes of section 735(a)(2)).

[20] Situation 2. The CD partnership terminates under section 708(b)(1)(A) when E purchases the entire interests of C and D in CD. C and D must report gain or loss, if any, resulting from the sale of their partnership interests in accordance with section 741.

[21] For purposes of classifying the acquisition by E, the CD partnership is deemed to make a liquidating distribution of its assets to C and D. Immediately following this distribution, E is deemed to acquire, by purchase, all of the former partnership's assets. Compare Rev. Rul. 84-111, 1984-2 C.B. 88 (Situation 3), which determines the tax consequences to a corporate transferee of all interests in a partnership in a manner consistent with McCauslen, and holds that the transferee's basis in the assets received equals the basis of the partnership interests, allocated among the assets in accordance with section 732(c).

[22] E's basis in the assets is \$20,000 under section 1012. E's holding period for the assets begins on the day immediately following the date of sale.

DRAFTING INFORMATION

[23] The principal author of this revenue ruling is Matthew Lay of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling contact Mr. Lay at (202) 622-3050 (not a toll-free call).