NEAL GERBER EISENBERG

Purchases of Partnership and LLC Interests Adversely Affected by Newly-Proposed Regulations Under Code Section 199A

October 9, 2018

Historically, we have advised clients that it is no less advantageous, from a federal income tax perspective, to acquire a partnership interest (including a membership interest in an LLC taxed as a partnership) than it would be to acquire the underlying assets of the partnership, even when those assets have appreciated in value. When acquiring a partnership interest (but less than 100% of the partnership), as long as a timely election under Section 754 of the Internal Revenue Code (the "Code") is made by the entity (a "754 Election"), the purchaser will receive the same tax benefits he would have received if he had instead purchased his share of the entity's underlying assets (i.e., a step-up in the basis of the entity's assets). However, as a result of the recently-issued Proposed Section 199A Treasury Regulations (regarding the 20-percent deduction for income from pass-through entities), we have become concerned that purchasers of partnership interests may be worse off than purchasers of a partnership's assets.

Notably, even if the partnership has a low tax basis in its assets, if a 754 Election is made then the purchaser will be entitled to the same depreciation deductions to which he would have been entitled if the partnership's tax basis in its assets was equal to their fair market value (based on the amount the purchaser paid for his interest). Similarly, if a 754 Election is made, gain allocated to the purchaser upon a subsequent sale of the entity's assets will be determined with reference to the amount paid by the purchaser for the interest in the entity, and not the entity's historic tax basis in the assets. In contrast, when a taxpayer purchases stock of a corporation (whether an S corporation or a C corporation), there is ordinarily no adjustment to the basis of the corporation's underlying assets, which results in lower depreciation deductions for the corporation, and additional gain upon a sale of the corporation's assets, than would be the case if the asset basis were adjusted upon the purchase of stock.

To illustrate, assume that partners A and B both own a 50-percent interest in Partnership AB, and that Partnership AB owns two assets, X and Y. Assume further that partnership assets X and Y are both depreciable, and that each asset has a tax basis of zero and a fair market value of $100. Finally, assume that purchaser P purchases A's 50-percent interest in Partnership AB for $100. Prior to the sale by A to P, A is not entitled to any depreciation deductions because Partnership AB's basis in its assets is zero. However, upon a sale of A's interest to P, assuming that a 754 Election is made by Partnership AB, P will be entitled to an allocation of depreciation deductions from Partnership AB as if A's share of the basis in Partnership AB's assets was equal to A's $100 purchase price for the interest in Partnership AB. In other words, there has been a step-up in the basis of Partnership AB's assets solely with respect to P's newly-acquired interest. Similarly, if Partnership AB sold asset X for $150 for a gain of $150 (because Partnership AB had a tax basis of zero), then P would be allocated gain of only $25 based on his 50-percent share of the post-purchase $50 appreciation in asset X, and P would not be taxed on his share of the partnership's first $100 of gain because P's basis in the asset would be deemed to be $50 (based on asset X having a value of $100 at the time of P's purchase of a 50-percent interest in Partnership AB).

TAXATION ALERT

For the above reasons, we have historically been agnostic about the tax consequences to a purchaser of a partnership interest. However, as a result of the recently-proposed regulations under Code Section 199A, we are now concerned that purchasers of partnership interests may be in a worse tax position than purchasers of the underlying assets.

Code Section 199A generally provides for a deduction of 20 percent of the qualified business income ("QBI") of a "qualified trade or business" conducted as a pass-through entity, such as a sole proprietorship, S corporation, partnership, or LLC taxed as a partnership. Subject to certain important exceptions, the benefits are phased out if the taxpayer's taxable income exceeds $157,500 ($315,000 if married filing jointly), and the benefits are eliminated if a taxpayer's taxable income exceeds $207,500 ($415,000 if married filing jointly). However, for those taxpayers whose taxable income is above the threshold amounts, the 20-percent deduction may still be available, but it is limited to the greater of: (a) 50 percent of the entity's W-2 wages allocable to QBI; or (b) the sum of 25 percent of the entity's W-2 wages allocable to QBI plus 2.5 percent of the trade or business's unadjusted basis immediately after acquisition ("UBIA") of all qualified property. "Qualified property" includes tangible property of a character subject to the allowance for depreciation under Code Section 167 and (i) which is held, or available for use, in a trade or business at the close of the tax year, (ii) used by the trade or business during the tax year in the production of QBI, and (iii) for which the depreciable period has not ended before the close of the tax year. UBIA is based on the original purchase price for an asset as of the date it was placed in service.

While asset basis is re-determined for depreciation and gain recognition purposes (as described above) upon a sale of an interest in a partnership (if a 754 Election is in effect), under Proposed Treasury Regulation Section 1.199A-2(c)(1)(iii), basis adjustments under Code Sections 734(b) and 743(b) are not treated as qualified property and, consequently, UBIA is not re-determined upon the sale of a partnership interest for purposes of calculating the limitation on the availability of the 20-percent deduction to the purchasing partner. This means that a person who purchases a partnership interest will not be able to re-compute his UBIA based on the amount paid for the interest, even if a 754 Election is made by the entity.

To illustrate this problem, assume that Partner B in the example above sells her 50% interest in Partnership AB to C for $100. If a 754 Election is made, C will be able to compute his annual depreciation deductions based on the $100 that he paid for the partnership interest. However, the entity's UBIA may still be zero. This means that if C is subject to the income limitations which require him to use the deduction limitation based on 25-percent of W-2 wages and 2.5-percent of UBIA set forth above, then his share of Partnership AB's UBIA would be zero for purposes of calculating the 2.5 percent annual deduction limitation component, which would put him in a substantially worse off position than if he had purchased his share of the underlying assets directly and then contributed them to the partnership.

For those taxpayers for whom the UBIA computations may be a material consideration and who are seeking to purchase in interest in an existing partnership from a selling partner, it may be beneficial first to have the partnership distribute assets to the selling partner, then to have the taxpayer purchase the distributed assets from the selling partner, and finally to have the taxpayer hold the assets as co-tenants with the partnership. Alternatively, a taxpayer may attempt to purchase the assets from the selling partner and then contribute the purchased assets to the partnership. This, of course, would increase the risk that the IRS would disregard the distribution to the selling partner and the contribution by the purchasing partner, and would instead treat the purchaser as having simply purchased a partnership interest from the selling partner, thereby resulting in no increase to the partnership's UBIA.

If you have questions regarding the application of Section 199A to your personal situation, please contact your attorney Neal Gerber Eisenberg.

• • • • • • • • • •

This alert was authored by Scott J. Bakal (312-269-8022, sbakal@nge.com),
Jeffrey S. Shamberg (312-269-8492, jshamberg@nge.com) and
Eric M. McLimore (312-269-5215, emclimore@nge.com).

If you have any questions related to this article or would like additional information,
please reach out to your contact in the Taxation group, or the authors.

TAXATION ALERT