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Capital Gains on Sales of Interests in Pass-Through Entities

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The IRS issued proposed regulations last August under Internal Revenue Code ("Code") section 1(h) concerning the classification of gain recognized upon the sale or exchange of interests, held for more than one year, in certain pass-through entities (REG-106527-98).

Setting aside other Code provisions that may treat a portion of the proceeds or of the gain as ordinary income, such gain may, under these regulations, be "collectibles gain," subject to tax at a maximum stated rate of 28%; "section 1250 capital gain," subject to tax at a maximum stated rate of 25%; or other ("residual") long-term capital gain from the sale of capital assets, subject to tax at a maximum stated rate of 20%. As discussed below, the character of the gain is determined in many instances by reference to the properties held by the pass-through entity.

"Section 1250 capital gain" as defined in the proposed regulations includes, generally, gain to the extent of depreciation previously claimed with respect to depreciable real property, except to the extent such gain is treated as ordinary income under Code section 1250. Accordingly, these rules may have a significant impact on the tax treatment of dispositions of interests in partnerships that own real property.

Another proposed regulation issued at the same time addresses the determination of holding periods for partnership interests that are acquired by a partner at different times, or in exchange for property transferred at the same time in a transaction that results in different holding periods (e.g., because the transferor had different holding periods in the various properties transferred).

Specific Provisions

If gain is required to be recognized upon the sale or exchange of an interest in a partnership (or in a limited liability company or other entity that is classified as a partnership for Federal tax purposes), the transferor is required to treat the gain as section 1250 capital gain to the extent of the section 1250 capital gain that would be allocated to the transferor with respect to the interest transferred if, immediately before the transfer of the interest, the entity had transferred its section 1250 property in a fully taxable transaction. Thus, Code section 704(c), and any special allocation of gain under a partnership agreement, are potentially relevant to determining the amount of gain that will be treated as section 1250 capital gain.

If less than all of the gain realized upon the transfer of an interest is recognized (for example, because of the applicability of a nonrecognition provision such as Code section 351), the section 1250 capital gain required to be recognized is determined as if the entity had transferred a proportionate part of each section 1250 property, determined as a fraction equal to the amount of gain that is recognized (for example, by reason of the receipt of cash or other "boot") divided by the amount of gain that is realized in the sale or exchange.

Collectibles

"Collectibles gain" is defined as gain from the sale or exchange of a collectible held for more than one year. A "collectible" is defined elsewhere in the Code to include, among other things, works of art, antiques, and stamps and coins.

The rules for determining the portion of the recognized gain to be treated as collectibles gain are essentially the same as those described above with respect to section 1250 capital gain, but apply not only to the sale or exchange of an interest in a partnership but also to the sale or exchange of shares in an S corporation or an interest in a trust (if transferred by a person not treated as owning a portion of the assets of the trust).

The proposed regulations provide, as an example, a situation in which a partner ("B") sells a 50% interest in a partnership for consideration (cash plus relief from partnership debt) of $16,000. The partnership is assumed to own unrealized receivables with an adjusted basis of zero and market value of $14,000, collectibles with an adjusted basis of $1,000 and market value of $3,000, and other assets. B had held the interest in the partnership for more than one year and had a basis in the partnership interest of $10,000.

Under Code section 751, B must recognize ordinary income to the extent of B's share of the unrealized receivables, which was $7,000. In addition, under Code section 1(h) and the proposed regulations, B recognizes $1,000 of collectibles gain (i.e., 50% of the unrealized appreciation of $2,000).

The section 751 income is subtracted from the amount of gain otherwise required to be recognized in determining the capital gain on the sale ($6,000 in this case), and a similar approach applies with respect to the collectibles gain. Thus, B has a residual long-term capital loss of $2,000, computed as the long-term capital loss that would otherwise have resulted by reason of the application of section 751 ($6,000 - $7,000 = -$1,000) minus the $1,000 of gain treated as collectibles gain.

With regard to tiered entities, the proposed regulations provide that a partnership, S corporation, or trust is treated for purposes of these rules as owning its proportionate share of the property of any partnership, S corporation or trust in which it owns an interest.

Notification rules similar to those which now apply under Code section 751(a) will also apply in the case of a sale or exchange of an interest in a partnership, S corporation, or trust that holds property with collectibles gain, or of an interest in a partnership that holds property with section 1250 capital gain. Under those rules, if there is a sale of an interest in a partnership and any portion of consideration received is attributable to "section 751 property" (which includes receivables not previously included in income, and certain depreciable property and inventory items), the seller is generally required to inform the partnership of the sale within 30 days of the transfer, and the partnership is in turn generally required to provide to the transferor and transferee, and to the IRS, the information required to be shown on Form 8308.

Divided Holding Periods

Each partner of a partnership is generally viewed (albeit on the basis of limited authority) as having a single, unified basis in the partner's interest, regardless of whether the interest was acquired in one transaction or in several transactions. It is unclear, however, how the holding period for a partner's interest should be determined in situations where partnership interests are acquired at different times, or at the same time in exchange for both (i) property within the scope of the holding period "tacking" rules of Code section 1223 and (ii) cash or other property not within the scope of those rules.

The proposed regulations generally provide that a partner has a "divided holding period" in the situations described above. In general, the divided holding period is determined by reference to relative fair market values.

For example, if cash of $5,000 and a nondepreciable capital asset (say, land held for investment) with a value of $10,000 are contributed to a partnership in exchange for an interest having a value of $15,000, and the transferor has a holding period of two years in the land at the time of contribution, the transferor will have a holding period in one-third of the partnership interest received that begins the day after the contribution, and a holding period in two-thirds of the partnership interest that includes the period during which the transferor held the land.

The proposed regulations also address how the divided holding period is to be taken into account if a partner sells an interest in the partnership, or is required to recognize capital gain or loss as a result of a distribution from the partnership (for example, if cash is distributed to a partner in excess of the partner's basis in the partnership interest).

Upon the sale or exchange of a partner's entire interest, any resulting capital gain or loss is to be divided between long-term and short-term capital gain or loss in the same proportion as the holding period of the partnership interest is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less.

If a partner is required to recognize capital gain or loss by reason of a sale or exchange of a portion of the partner's interest or a distribution with respect to that interest, that gain or loss is to be divided into short-term and long-term components in the same proportions as the long-term and short-term capital gain or loss that would have been realized if the entire partnership interest had been transferred in a fully taxable transaction immediately before the partial sale or distribution.

If an ownership interest in a so-called "publicly traded partnership" is divided into identifiable units, however, and a seller of units is able to identify the units sold and when they were acquired, the seller may use the actual holding period of the units transferred.

But for the narrow exception stated in the preceding paragraph, the proposed regulation does not permit the determination of holding periods by reference to specific identification. A person contemplating the acquisition of an interest or an additional interest in a partnership may, however, be able to achieve substantially the same result as specific identification by causing interests to be acquired through different entities.

The preamble to the proposed regulations notes the potential application of the anti-abuse regulations promulgated under Code section 701, and of step transaction principles and other judicial doctrines, in potentially abusive situations such as where, for example, property with a short-term holding period is contributed to a partnership and the transferor's partnership interest is sold soon thereafter with a view to causing a portion of the gain to be classified as long-term capital gain.

The amendments are proposed to apply to transfers of interests in partnerships, S corporations, and trusts, and to distributions of property from a partnership that occur on or after the date the regulations are published in final form.

Observations

The proposed regulations relating to the classification of gain and loss from the sale or exchange of interests in certain pass-through entities appear to be fairly straightforward, and consistent with language in the statute and statements in committee reports relating to the intended application of the various tax rates referred to above in the context of sales of interests in pass-through entities. Significant administrative burdens may be anticipated, however, with respect to the tracking of transfers of interests, and of the fair market values of partnership property at the time of each transfer, that may be necessary to compute the appropriate allocations.

The proposed holding period rules are more controversial for a variety of reasons, including longstanding conceptual issues as to the treatment of partnership interests and questions as to administrative practicality. It is far from clear that the blended holding period approach being proposed is the best approach to this difficult issue, and this approach will produce peculiar results in specific instances.

For example, if cash is contributed by partners to a partnership (even pro rata) within a year before they sell their interests, a portion of any resulting capital gain will apparently be short-term, even if the partnership was formed and its property acquired years before the sale.

From an administrative perspective, if a partnership interest is acquired in exchange for multiple properties, the application of these rules may require a determination, as of the date of the exchange, of the fair market value of each property transferred and of the partnership interest received. Even before the regulations are finalized, partnerships should consider assembling and recording this information at the time interests are so issued.

It may be anticipated that, in the context of an acquisition of an additional partnership interest, the determination of the portion of the acquiror's interest that is acquired in the later transaction will present difficulties in many instances.

As a planning matter, taxpayers contemplating the acquisition of interests or additional interests in partnerships, including an acquisition in the form of a capital contribution with respect to a preexisting interest, should consider whether the holding period for the interest acquired is likely to be of concern in connection with a subsequent sale or distribution, and, if so, what can or should be done in light of the proposed regulations to achieve the best possible result.