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Partnerships, S Corporations, & LLCs

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Michael P. Spiro [FNa1]**TAX-DEFERRED MANAGEMENT ROLLOVERS IN ACQUISITIONS OF PASS-THROUGH ENTITIES**

A plethora of tax considerations affects the analysis and structuring of acquisitions of S corporations, LLCs, and limited partnerships. A comparison of the basic structure of such transactions and the tax goals of each of the parties, along with the common concerns and issues that should be addressed, can assist in structuring the transaction for maximum tax efficiency.

Where a management-owned company operated as an S corporation, LLC, or limited partnership is acquired by a financial buyer, it is often in the best interest of the acquiror to retain current managers as owners and employees of the company. Existing owners are generally the people who have built the business, and who have primary knowledge and skill in conducting the business. In a competitive bidding situation, it is often paramount that acquirors be able to accomplish the continuation of management ownership on a tax-deferred basis (a 'management rollover'). Moreover, the sellers often can achieve tax savings by agreeing to a lower overall purchase price.

While there are several strategies for accomplishing management rollovers, one technique that has become increasingly popular in recent years involves the use of an LLC as the acquisition entity. When properly structured, an LLC can provide significant flexibility and tax efficiency in facilitating a management rollover. Of particular importance, use of an LLC can combine a tax-free management rollover with a step-up in the acquiror's basis in the assets of the target, resulting in both tax deferral for the seller and valuable depreciation and/or amortization deductions for the acquiror.

BASIC STRUCTURE AND TAX GOALS

Generally, a management rollover acquisition of a pass-through entity will occur using some variation of the following structure: P, a private equity fund, desires to purchase the business of T, an S corporation or LLC, from the current owner-employees of T. P intends to make an equity investment in T, and then incur debt at the level of the acquisition entity to complete the purchase. [FN1] P and the owners of T agree that the current owners should retain an interest in the T business. P and the T sellers generally will have the following tax goals in structuring the acquisition.

P's tax goals. P generally will have the goal of obtaining a full step-up in the basis of the depreciable and amortizable assets of T. This basis increase will allow valuable deductions that will increase the cash flow of P's investment. In that connection, P generally will have an interest in minimizing the allocation of the purchase price to nondepreciable assets such as inventory and raw land.

Financial buyers concerned about subsequent exit from the investment also will wish to structure the investment so as to provide subsequent purchasers with a stepped-up basis. In that connection, structuring the transaction to retain the pass-through taxation of the investment is highly advantageous, as the acquiror will be in a position to offer a subsequent purchaser a stepped-up basis in the assets of the company without incurring entity-level federal income tax as a result.

[FN2]

T's tax goals. The sellers generally will have the twin goals of deferring tax on their continued investment (i.e., avoiding recognition with respect to the amount of the management rollover), and of characterizing their remaining gain as long-term capital gain. They thus will be concerned with:

1 Obtaining tax-deferred rollover treatment on the rollover investment.

2 In a partnership, minimizing the allocation of the purchase price to 'hot assets' that will give rise to ordinary income. [FN3]

3 In an S corporation, minimizing the allocation of the purchase price to property with 'net unrealized built-in gain' that will give rise to entity-level tax. [FN4]

4 Ensuring that the creation of an LLC structure does not distort their otherwise available holding period with respect to capital assets.

Tax deferral is not necessarily desirable in all cases. Currently, it is unknown whether the federal long-term capital gains rate will remain at 15% or increase to 20% or higher, as has been proposed in President Obama's fiscal-year 2010 budget. [FN5] Depending on the expected appreciation of the investment and the length of the term for which the sellers intend to hold their rollover interests, deferral of tax may or may not be advantageous. Where rates remain constant over the course of the investment, deferral always will be of value. Where rates are expected to increase, however, a tax practitioner would be well advised to weigh the economic benefits and drawbacks of deferral.

For example, consider some simple calculations of the present value rate of tax over five years (that is, the net present value of the tax that would be due on \$1 of income earned in 2009, expressed as a percentage). If a 5% discount rate is used (i.e., the taxpayer expects to generate a 5% internal rate of return on its investment), then the present value tax rates will be as shown in Exhibit 1. [FN6]

Exhibit 1. Net Present Value Using 5% Discount Rate

Year	Discounted tax	Discounted tax	Discounted tax
	rate assuming 15%	rate assuming 20%	rate assuming 35%
	long-term capital	long-term capital	long-term capital
	gains rate	gains rate	gains rate
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2010	14.29%	19.05%	33.33%
2011	13.61	18.14	31.75
2012	12.96	17.27	30.23
2013	12.34	16.45	28.79

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2014	11.75	15.67	27.42
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In this situation, if the practitioner suspects (or knows) that the long-term capital gains rate will increase to 20% or higher, she may advise against tax deferral. If, however, the discount rate is raised to 7%, the results differ, as shown in Exhibit 2. In this instance, if the sellers expect to hold their interests for five years or more, deferral will be advisable if rates increase to 20% (as the present value of a 20% rate (14.26%) is still less than 15%). If rates increase to 35%, however, deferral would not be advisable.

Exhibit 2. Net Present Value Using 7% Discount Rate

Year	Discounted tax	Discounted tax	Discounted tax
	rate assuming 15%	rate assuming 20%	rate assuming 35%
	long-term capital	long-term capital	long-term capital
	gains rate	gains rate	gains rate
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2010	14.02%	18.69%	32.71%
2011	13.10	17.47	30.57
2012	12.24	16.33	28.57
2013	11.44	15.26	26.70
2014	10.69	14.26	24.95

The remainder of this article assumes that, after careful analysis, the practitioner has determined that deferral is advisable (either because long-term capital gains rates are not expected to rise significantly or because the seller intends to hold its interest for sufficient time, and to generate a sufficient return, to make deferral valuable despite increased rates).

TAX ISSUES IN THE TRANSACTION

In order to meet the tax goals of both P and T, many technical tax issues must be considered.

Anti-Churning Rules

The anti-churning rules in Section 197(f)(9) disallow the amortization of goodwill created prior to 8/11/93 by persons who owned the goodwill at that time and 'related persons.' Thus, where T's existence predates 8/11/93, the transaction

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must be structured so as to ensure that the anti-churning rules will not prohibit P from amortizing its basis step-up in the goodwill of T. [FN7] Furthermore, if possible, the parties will prefer to structure the investment in a manner that will permit the owners of T to amortize their rollover interest in whole or in part. Structuring options to navigate the anti-churning rules will depend on T's entity type prior to the acquisition and the size of the management rollover. Specifically, the means of approaching the situation will depend in large part on whether T is an entity taxed as an S corporation or an entity taxed as a partnership for federal income tax purposes. [FN8] The importance of T's entity type is primarily due to a particular wrinkle in the anti-churning rules on the definition of 'relatedness' in their application.

Generally, in the context of acquisition transactions between otherwise unrelated parties, relatedness will exist where an owner (or person related thereto) of the goodwill prior to 8/11/93 owns more than 20% of the entity subsequently attempting to amortize the goodwill. [FN9] If, however, basis in goodwill is obtained via the operation of Section 732(b), [FN10] Section 732(d), [FN11] or Section 734(b) [FN12] (along with Section 743; collectively, the 'special basis rules of Subchapter K'), relatedness is tested at the *partner* level rather than at the *partnership* level (that is, the relevant relatedness is between the distributee partners and the partners attempting to deduct their distributive share of amortization expense, rather than between the distributee partners and the partnership as an entity). Accordingly, when a basis adjustment arises under one of these aforementioned sections as a result of a distribution to a partner who has held his or her interest since before 8/11/93, such distributee partner will never be permitted to share in such basis increase (as he or she is, by definition, related to himself or herself).

Nevertheless, where the other partners of such a partnership are not related to such distributee partners (by some reason other than common ownership of the partnership at issue), those 'eligible partners' typically will be entitled to their share of amortization deductions, even where the distributee partners continue to own more than 20% of the entity. Basis adjustments to goodwill obtained pursuant to Section 743(b) [FN13] are not subject to the anti-churning rules at all so long as the transferee partner with respect to whom the Section 743(b) adjustment is made is not related to the transferor partner. The discussion herein assumes that P and T are not related to one another outside of the context of the acquisition transaction.

T is an S corporation. If T is an S corporation formed prior to 8/11/93, a management rollover transaction is often structured by having T first form a subsidiary LLC as a disregarded entity. [FN14] P will then use its equity investment to purchase interests in the LLC (the 'equity purchase'), [FN15] and incur debt at the LLC level to redeem all but the continuing management interests (the 'leverage purchase'). For federal income tax purposes when T forms the LLC as a wholly owned subsidiary, the LLC will be a disregarded entity immediately prior to P's equity investment. IRS guidance has indicated that on the equity purchase, P will be treated as having purchased a pro rata portion of each of the assets of the LLC; T and P then will be treated as making a joint contribution of those assets to a newly formed tax partnership. [FN16] Immediately thereafter, the LLC will make a distribution of debt proceeds to T.

Generally, when property is contributed to a partnership, and a distribution of money is made to the contributing partner within two years of the contribution, it is presumed that the contribution and distribution constitute a 'disguised sale' of property to the partnership by the contributing partner. [FN17] Such sale is deemed to have occurred on the date of the contribution of property to the partnership. [FN18] Accordingly, the leverage purchase [FN19] generally will be deemed to constitute a disguised sale of assets by T to the LLC, and, on the LLC's 'purchase' of those assets in the disguised sale, it will obtain a cost basis in the assets under Section 1012. [FN20] Thus, when the transaction is structured via the use of a subsidiary single-member LLC, basis in the goodwill is acquired via the contribution and purchase of assets. Because this does not implicate the special basis rules of Subchapter K, relatedness will be tested at the entity level.

The anti-churning rules require that relatedness be tested immediately before and immediately after a 'series of related

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transactions. [FN21] Accordingly, relatedness should be tested after the leverage purchase (and not between the equity purchase and the leverage purchase). If after the leverage purchase T owns 20% or less of the LLC, the LLC generally will be entitled to amortize its basis in the goodwill (which will be equal to approximately 80% or more of the total value of the goodwill) without such deduction being barred by the application of the anti-churning rules. By contrast, if after the leverage purchase T owns more than 20% of the LLC, the LLC likely will be barred from amortizing any of the goodwill acquired from T, including goodwill acquired in the equity purchase.

Structuring alternative: Partnership characterization. To mitigate the consequences of the anti-churning rules where entity-level relatedness is likely to exist, the structure of the transaction may be altered so that some or all of the basis adjustments will come by way of a Section 743(b) adjustment and thus be exempt from application of the anti-churning rules. In order to accomplish this change in characterization, the parties must ensure that prior to the equity purchase the LLC is a tax partnership rather than a disregarded entity. Generally, an LLC will be treated as disregarded when it has only one owner, and as a partnership where there are two or more owners. [FN22] Thus, if, in forming the LLC one or more shareholders of T make a separate side investment therein, the LLC could be characterized as a partnership prior to the equity purchase rather than as a disregarded entity.

If so characterized, the equity purchase will be treated not as a purchase of assets by P from T but rather as a purchase of a partnership interest by P. [FN23] So long as the LLC has a Section 754 election in place prior to the equity purchase, the purchase will result in an adjustment to inside basis under Section 743(b) that will increase P's share of the inside basis of the T assets so that after the equity purchase P's share of inside basis will equal the amount of the equity purchase price. Section 743(b) adjustments are separately depreciable or amortizable by the purchasing partner (i.e., the depreciation and/or amortization deductions are not shared) [FN24] and, as noted above, are not subject to the anti-churning rules unless P and T are related. Accordingly, by structuring the equity purchase as the purchase of a partnership interest rather than as a purchase of assets, the equity purchase amount may avoid the application of the anti-churning rules. As is discussed in more detail below, basis increases attributable to the leverage purchase will remain subject to the anti-churning rules.

Problems of partnership characterization. The law of unintended consequences is a constant in the context of partnership taxation. Each structuring solution presents new problems. The creation of a tax partnership invokes several potential concerns that will need to be addressed by a tax advisor.

Holding period. If the equity purchase is treated as a purchase of a partnership interest, care must be taken to ensure that, for purposes of characterizing T's gain on the sale of its LLC interests as long-term capital gain, T has the requisite holding period of more than one year in its LLC interests.

Under Section 1223, on the contribution of property to form a partnership, the holding period of the partnership interest will generally include the holding period of the contributed property. Where short-term property is contributed to a partnership, however, the holding period in the partnership interest is divided, so that on a disposition of the interest the gain bearing the same ratio to total gain as the FMV of the short-term property bears to the total value of the interest is treated as short-term capital gain.

The most problematic example of this treatment involves the contribution of cash to the LLC. For example, if the total value of property contributed to the LLC is \$23 million, including \$4.6 million of cash and \$18.4 million of long-term assets, then on a sale of an 80% interest in the LLC for \$18.4 million, 20% of the gain recognized on the sale will be short-term. [FN25]

Cash will not be taken into account to the extent distributed back to the contributing partner prior to the purchase of its

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interest. This concern can thus be ameliorated by either (1) distributing contributed cash back to T prior to the equity purchase, or (2) making cash available through a subordinated loan rather than through a capital contribution.

Another area in which holding period concerns might be raised is in the contribution of certain ordinary income assets described in Section 751. Under that section, when a partnership interest is sold, gain is generally capital except to the extent allocated to ‘hot assets.’ These include inventory and ‘unrealized receivables’ (which generally includes depreciation recapture under Section 1245). Often, in sales of partnership interests, sellers will attempt to negotiate purchase price allocations that do not result in significant ordinary income. For example, sellers may request that purchase price be allocated to inventory only to the extent of the partnership's basis therein in order to avoid the recognition of ordinary income to the extent of gain allocable to inventory under Section 751(a).

Under these circumstances, however, this strategy will be unavailing. Even if no value in excess of basis is ascribed to the inventory, gain on the sale of the partnership interest will be short-term capital to the extent of proportionate value attributable to the investment (and thus taxed at ordinary income rates) in the manner described above. The Regulations do, however, provide that Section 751 assets will not be taken into account in determining holding period if ordinary income is recognized with respect thereto on the sale of the partnership interest. [FN26] Thus, where the LLC interests being sold are characterized as partnership interests, it may be in the best interest of the seller to allocate a moderate, but justifiable amount of the purchase price in excess of basis to short-term hot assets.

Disguised sale. Characterizing the equity purchase as the purchase of a partnership interest rescues P's share of the basis step-up in T's goodwill attributable to the equity purchase from the application of the anti-churning rules. As noted above, however, the contribution of T (which for purposes of this discussion will include all initial partners of the LLC, e.g., T and a co-investing shareholder) to the LLC, followed by the distribution of the debt proceeds to T within two years, will give rise to a presumption of disguised sale on the date of initial contribution. Thus, where after the leverage purchase T continues to own more than 20% of the LLC, the anti-churning rules will continue to bar any amortization of goodwill purchased by the LLC in the leverage purchase.

Moreover, unlike the case where the LLC is a disregarded entity, the contribution to the LLC ‘tax partnership’ occurs prior to the equity purchase (rather than immediately after the equity purchase). Thus, on the effective date of the disguised sale, T owns more than 50% of the LLC (as the disguised sale is presumed to occur on the first to occur of the contribution of property or related distribution). This technical distinction implicates Section 707(b)(2), which provides that ‘[i]n the case of a sale or exchange, directly or indirectly, of property, which in the hands of the transferee, is property other than a capital asset as defined in section 1221—(A) between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership ... any gain recognized shall be considered as ordinary income.’

Section 707(b)(2) applies to treat all gain on such a sale as ordinary—including gain attributable to the purchase by the related partnership of property described in Section 1231 (depreciable property used in a trade or business). This would typically include all equipment of T, as well as amounts allocated to the goodwill of T. Accordingly, there is a substantial argument that, if characterized as a disguised sale, T's gain attributable to the leverage transaction will be treated as ordinary income. This often will be an unacceptable result for the shareholders of T.

Disguised sale structural solution. It may be possible to structure the transaction to avoid the disguised sale problem described above by taking advantage of one of several safe harbors from the disguised sale presumption of Reg. 1.707-3. Specifically, the relevant Regulations provide that no presumption of a disguised sale arises where debt proceeds are distributed pro-rata among all partners. [FN27] In order to fit within this safe harbor, the acquisition transaction may be

altered so that the entire purchase price [FN28] is treated as being paid in respect of a purchase of partnership interests.

Thus, instead of making a disproportionate distribution of debt proceeds to T in the leverage purchase, P would, in the equity purchase step, pay to T the sum of (1) an amount of cash equal to the equity purchase price plus (2) a short-term note for its proportionate share of the total leverage to be borrowed in the leverage purchase. [FN29] Shortly after the equity purchase, the LLC would borrow the full leverage amount, and distribute it, pro rata to P and T. Immediately thereafter, P would pay the amount distributed to it to T in full satisfaction of its note. Structuring the transaction in this manner has the intended effect of causing the basis step-up attributable to both the equity purchase and the leverage purchase to arise via a Section 743(b) adjustment (which is not subject to the anti-churning rules), and to avoid Section 707(b).

Of course, this structure is highly technical and could be subjected to an IRS attack on economic substance grounds. If so inclined, the Service presumably would challenge this structure by arguing that because the note from P to T is very short-term, and is ultimately paid by the proceeds of an LLC-level financing that was contemplated (if not committed to) prior to its origination, the short-term note should be disregarded, and the transaction should be recharacterized as a distribution directly from the LLC in redemption of interests.

Such an argument, if successful, only restores the presumption in favor of a disguised sale. P and T still could attempt to rebut that presumption based on the facts and circumstances of the transaction. To the extent that the short-term note can be delivered prior to a loan commitment at the LLC level, the taxpayer's position will be bolstered, albeit at the cost of increased economic risk to P.

T is an entity taxed as a partnership. Where T is an existing partnership or LLC with more than one member formed prior to 8/11/93, many of the issues set forth above will not apply (as they are based in large part on the application of the disguised sale rules to contributions within two years of distributions). Instead, where T is an existing tax partnership, P typically will purchase interests in T from the partners or members of T in the equity purchase and redeem additional interests in the leverage purchase. Management will simply keep interests that it intends to roll over. As discussed above, the equity purchase generally will be treated as the purchase of a partnership interest and will give rise to a basis adjustment under Section 743(b).

Unlike the case discussed above, however, the leverage purchase generally will not be treated as a disguised sale (assuming that T has been in existence as a tax partnership for more than two years). Instead, the leverage purchase will be treated as a distribution, and will give rise to a basis adjustment under Section 734(b). That section provides that when a Section 754 election is in effect, on a distribution to a partner with respect to which the partner recognizes taxable gain or loss, the basis of the partnership's assets will be increased or decreased by the amount of the gain or loss recognized on the distribution. [FN30]

As noted above, when basis in goodwill is adjusted under Section 734(b), relatedness is tested at the partner level, rather than at the partnership level. Thus, regardless of whether the rollover members of T own more than or less than 20% of the T interests after the redemption, the basis step-up in the asset basis will be amortizable by 'eligible partners' of T [FN31] and not by the rollover members. Generally, 'eligible' partners are partners other than the distributee partner where the distributee partner was a partner prior to 8/11/93, and all partners where the distributee partner acquired its interest after 8/10/93. [FN32] Thus, where the continuing members of management were partners or members of T prior to 8/11/93, amortization deductions allocated to them in respect of the Section 734(b) adjustment generally will not be deductible by them. By contrast, as is noted above, because relatedness with respect to basis adjustments pursuant to a disguised sale is evaluated at the entity level rather than at the partner level, the same transaction, when treated as a dis-

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guised sale, would permit the rollover members to amortize their proportionate share of the basis increase attributable to the leverage purchase so long as the rollover members own 20% or less of the LLC.

Given this substantial difference, *query* whether it would be possible to create a disguised sale by having T form a subsidiary LLC (as was done where T is an S corporation) into which it transfers its assets and liabilities. As noted above, the LLC will be a disregarded entity whose creation will not have a tax impact. [FN33] The transaction then could be structured in the same manner as when T is an S corporation. That is, the equity purchase would be treated as a purchase of assets followed by a joint contribution of property to a newly formed tax partnership; and the leverage purchase would be treated as a disguised sale. So long as T owned 20% or less in the resulting tax partnership, it seems that the position could be taken that T's distributive share of the amortization deductions relating to the leverage purchase could be deducted by T's partners or members. Indeed, the argument would be no less persuasive than where T is an S corporation and structures its transaction in the same manner. Changing the structure of the transaction in this manner can thus have a significant impact where a target is subject to the anti-churning rules.

As a policy matter, it is, at best, puzzling why changing the form in this way ought to have a different tax impact. Nonetheless, the law is quite clear that in the case of basis adjustments to property other than under the specified special basis adjustment provisions of Subchapter K, relatedness is to be tested at the entity level. While the IRS may attempt to argue that no disguised sale exists in the present situation, it would be a difficult argument to make as the pass-through nature of partnerships makes the distinction between disguised sales of assets and undisguised redemptions of interests somewhat arbitrary in the context of redemption transactions. [FN34]

Basis Step-Up and Allocation of Deductions

Depending on how the anti-churning issues (if any) are resolved in structuring the transaction, a tax advisor must be attuned to the proper calculation and allocation of depreciation and amortization deductions. For ease of reference the following discussion refers only to amortization deductions, but will apply equally to depreciation deductions of tangible property. Once again, the salient issues raised will depend on T's entity type prior to the transaction.

T is an S corporation. As discussed above, where T is an S corporation, the characterization of the transaction will depend on whether, upon its formation by T, the LLC will be treated as a disregarded entity or whether, by contrast, T will attempt to form the LLC as a partnership in order to address concerns about the application of the anti-churning rules.

LLC is disregarded entity. As is noted above, where the LLC is formed as a disregarded entity, the tax characterization of the two steps of the transaction is as follows:

- 1 The equity purchase is treated as a purchase by P of a pro rata portion of each of the assets of the LLC, and a joint contribution by P and T of those assets to a newly formed tax partnership.
- 2 The leverage purchase is treated as a purchase by the tax partnership of those assets contributed by T.

After the transaction, the primary issue facing the tax practitioner will be the proper allocation of amortization deductions. The complications attendant to the proper allocation of these deductions are illustrated below.

Example 1: T is a management-owned S corporation formed in 1986, whose sole asset is goodwill with a zero basis and FMV of \$23 million. [FN35] P wishes to purchase an 80% interest in T, and to have management continue its 20% investment. P is not an eligible shareholder of an S corporation, and its direct purchase of stock will cause T to lose its S election and become a C corporation. In order to preserve the benefits of operating T as a pass-through entity, P decides to purchase T using the following structure:

- 1 T will contribute its assets and liabilities to a newly formed LLC. [FN36]

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2 P will purchase LLC interests for \$12 million (the equity purchase), and the LLC will borrow \$8 million, which it will distribute to T in redemption of interests (the leverage purchase).

Thereafter, P will own 80% of the LLC and T will own 20% of the LLC. As a common-sense matter, most would assume that (assuming that the full \$23 million aggregate value of T is attributable to goodwill) P would obtain the benefit of \$18.4 million of amortization deductions (the \$12 million of equity investment plus 80% of the \$8 million leverage). This result, however, does not necessarily arise as a natural outcome of the transaction.

For tax characterization purposes, the steps of the transaction are as follows. First, in the equity purchase, P purchases goodwill worth \$12 million from T, and contributes it to the LLC. T likewise contributes the remaining \$11 million of goodwill to the LLC. Second, in the leverage purchase, the LLC acquires \$8 million of goodwill from T (thereby reducing the actual contribution by T in the equity purchase to \$3 million).

When the dust clears from these interrelated steps, the LLC is left with three conceptual assets:

- 1 \$3 million of goodwill with zero basis contributed by T (the ‘T goodwill’).
- 2 \$8 million of goodwill (with \$8 million basis) acquired by the LLC in the disguised sale transaction (the ‘LLC goodwill’).
- 3 \$12 million of goodwill (with \$12 million basis) contributed by P (the ‘P goodwill’). [FN37]

Only the \$3 million of goodwill with zero basis (the ‘rollover goodwill’) has a book-tax disparity subject to Section 704(c). The method selected for making allocations of amortization deductions in respect of this disparity will have a substantial impact on whether the ‘correct’ result will be reached. Specifically, results may vary considerably between use of the ‘traditional method’ of making Section 704(c) allocations described in [Reg. 1.704-3\(b\)](#) and the ‘remedial method’ described in [Reg. 1.704-3\(d\)](#). [FN38]

Traditional method. If the traditional method is selected for allocating amortization on the goodwill contributed by T, such goodwill will not be amortizable, as the ‘ceiling rule’ provides that ‘the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year.’ [FN39] Accordingly, while P may, as a capital accounting matter, be entitled to allocations of ‘book’ amortization of the \$3 million of goodwill contributed by T, there could be no corresponding allocation of ‘tax’ amortization (as none exists). The LLC goodwill and the P goodwill (neither of which would be subject to Section 704(c)) would be amortized over 15 years, and the amortization deductions for each will be allocated 80% to P and 20% to T. Thus, over time, the \$20 million of total amortizable basis will be allocated \$16 million to P and \$4 million to T.

Remedial method. If, by contrast, the remedial method is selected for allocating amortization of the T goodwill, then, as in the prior example, amortization of each of the P goodwill and the LLC goodwill will be allocated 80% to P and 20% to T for total amortization deductions of \$16 million to P and \$4 million to T. The \$3 million of T goodwill will be treated differently, however. Instead of being nonamortizable by the LLC, the \$3 million book value of the T goodwill will be amortized, and the book amortization will be allocated 80% to P and 20% to T. P’s total book amortization will therefore equal \$2.4 million, and T’s total book amortization will equal \$600,000. In order to allocate P tax amortization to match its book amortization, T would receive a ‘remedial’ allocation of income. With respect to the \$3 million of T goodwill, T would include income of \$2.4 million as remedial allocations, and P would receive \$2.4 million in amortization deductions. Thus, on a net basis, P would enjoy the benefit of \$18.4 million in amortization deductions, and T’s \$4 million amortization deductions would be offset by \$2.4 million of remedial income allocations, for net total amortization deductions of \$1.6 million (its 20% share of the \$8 million in debt).

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Because the choice of the proper allocation method under Section 704(c) is so often overlooked by tax attorneys, the selection presents a significant trap for the unwary. Savvy sellers often would be well-advised to have the traditional method applied. Buyers, by contrast, generally should insist on the remedial method. [\[FN40\]](#)

LLC is a partnership. Where T forms the LLC as a partnership, the analysis is less complex. The equity purchase gives rise to a Section 743(b) adjustment which is amortizable solely by P. [\[FN41\]](#) To the extent that the leverage purchase is treated as a disguised sale, basis will be amortized in accordance with T's and P's general distributive shares of LLC income, deduction, and loss. To the extent that the leverage purchase is treated as a purchase of partnership interests, then, as is noted above, the basis increase will arise by reason of Section 743(b) and be amortizable solely by P.

T is a partnership: Where T is an existing partnership, then, as noted above, the equity purchase will give rise to a Section 743(b) adjustment that will be amortizable solely by P. The leverage purchase, however, will give rise to a Section 734(b) adjustment. Generally, so long as the partners or members of T have outside basis that is equal to their share of inside basis, a Section 734(b) adjustment will produce the same aggregate basis in the assets as under a disguised sale. This is best illustrated by the following.

Example 2: Partnership AB has two partners, A and B, each of whom owns 50% of the capital and profits of the partnership. AB has two assets, real property that was contributed by A and B jointly, with a tax basis of \$50 (which A and B shared equally), book value of \$50, and FMV of \$100; and goodwill with a zero tax basis, zero book value, and FMV of \$200. The partnership's initial balance sheet is shown in Exhibit 3.

Exhibit 3. AB's Initial Balance Sheet

TABLETABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLEAB intends to borrow \$75 in nonrecourse debt to distribute to A in redemption of one-half of its interest in AB (leaving A with a 25% interest). Immediately after the \$75 is borrowed, the balance sheet of AB is as shown in Exhibit 4.

Exhibit 4. AB's Post-Debt Balance Sheet

TABLETABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLEIf the structure described in this example were not used, and instead the distribution of the \$75 was to be characterized as being paid in respect of a disguised sale of the real property and goodwill to the partnership, then A's and B's basis on contribution of the property would be disregarded, and the partnership would simply obtain a \$75 cost basis in the property on the distribution. Where, as in Example 2, there is no disguised sale, the analysis is a bit more complex.

When AB incurs the nonrecourse debt, each of A's and B's basis in their partnership interests (their 'outside basis') will be increased by their share of the debt. [Reg. 1.752-3\(a\)](#) provides that basis in nonrecourse liabilities is determined as follows:

- 1 In accordance with the partners' shares of partnership minimum gain.
- 2 In accordance with the sharing of any gain that would arise if the assets of the partnership were sold for the amount of the debt.
- 3 In accordance with the sharing of profits and losses by the partners.

[Reg. 1.704-2\(g\)\(1\)\(i\)](#) provides that a partner's share of partnership minimum gain is equal to the amount distributed to such partner allocable to a nonrecourse liability increasing partnership minimum gain. Partnership minimum gain is defined in [Reg. 1.704-2\(d\)\(1\)](#) as the 'gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability.' In this instance, if the real property and goodwill

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were disposed of for \$75, there would be aggregate gain to the partnership of \$25. Thus, partnership minimum gain is \$25. Because the entire \$75 is to be distributed to A, A's share of partnership minimum gain will thus be \$25. Accordingly, the first \$25 of basis attributable to the debt will be allocated to A.

The remaining \$50 of debt will be divided evenly between A and B, giving each \$25. Thus, of the \$75 in partnership debt, A will obtain \$50 in basis and B will have \$25 in basis under Section 752. A and B also each have \$25 in existing basis in their partnership interests that arose under Section 722 on their contribution of the real property with \$50 aggregate basis. Thus, when A receives a \$75 distribution, A will offset it by \$75 in aggregate basis, recognizing zero gain. The distribution also will reduce A's share of the nonrecourse debt by 50% (as A will, after the redemption, be only a 25% partner). Pursuant to Section 752(b), a decrease in a partner's share of a liability is treated as a distribution to that partner. Accordingly, A will be treated as having received a distribution of \$25 (50% of A's prior share of liabilities), on which A will recognize gain. Thus, \$25 will be the amount of the Section 734(b) adjustment.

Immediately after the distribution, AB will elect to revalue its assets and capital accounts to book value. [FN42] At that point, the partnership's balance sheet is as shown in Exhibit 5.

Exhibit 5. AB's Post-Revaluation Balance Sheet

TABLETABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLEUltimately, under both a disguised sale analysis and a Section 734(b) analysis, total basis in the property of AB is \$75. Of course, as noted above, if the property is subject to the anti-churning rules, amortization of goodwill allocable to 'ineligible partners' will be barred.

Moreover, the Section 734(b) analysis provides the same basis as a disguised sale only where the existing partners have shares of inside basis equal to their outside basis. Where this is not so, distortions may arise by virtue of a Section 734(b) adjustment. A disconnect between inside and outside basis will generally arise where there is no Section 754 election in effect and a new partner acquires its interest by transfer. [FN43]

Special Issues in Creation of a Holdco

Often, when leverage is contemplated, the parties will find it convenient to operate T through a two-tiered structure, whereby the operating entity is an LLC wholly owned by a holding company ('Holdco'). The reason for this structure is not tax related. Instead, this structure simply relates to the ease with which interests in the operating company may be pledged to the lender to secure the loan. Where the operating company is owned directly by P and T, each must agree to pledge its interest in T to the lender. When the operating company is owned by a holding company, however, only the holding company is required to pledge its interests in the operating company.

Generally, the creation of a Holdco will not have any impact on the tax structures discussed in this article, as, on the creation of Holdco, the operating entity will be disregarded. Nevertheless, there is one potential problem of which tax practitioners should be aware. Generally, the simplest means of forming Holdco from a tax perspective is for the T members (or T itself where T is forming a subsidiary LLC acquisition entity) to transfer the interests in T (or in the subsidiary LLC) to a newly formed Holdco prior to the equity purchase. Once that occurs, P's purchase occurs at the Holdco level (as Holdco and its subsidiary operating company are one tax partnership), and the analysis is as set forth above. Similarly, if Holdco is formed after the leverage purchase by T and P transferring their interests in T to a Holdco, no tax issues arise.

Sometimes, however, it will be suggested that P create Holdco prior to the equity purchase. [FN44] The management

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‘rollover’ members of T would then contribute their rollover interests in T to Holdco, and Holdco would acquire all of the remaining interests of T—either from those members of T being cashed out in the purchase, or from the rollover members to the extent that they are not continuing their investment. (For purposes of simplicity, the selling members will be referred to as the ‘remaining members.’) This construct could raise certain tax issues that must be addressed.

Example 3: T is a management-owned LLC, taxed as a partnership and formed in 1997, whose sole asset is goodwill. As in Example 1, above, P wishes to purchase an 80% interest in T, and to have management continue its 20% investment. P will pay \$12 million in equity (the ‘equity purchase’) and T will borrow \$8 million, which it will distribute to the members of T (the ‘leverage purchase’). The rollover members will roll over \$3 million. [FN45] Thereafter, P will own 80% of the LLC and T will own 20% of the LLC.

In order to facilitate the financing of the leverage purchase (by allowing for a simple pledge of interests in the operating company), P establishes an LLC (‘Holdco’) to which it contributes \$12 million in cash in exchange for interests therein, and the rollover members of T contribute to Holdco interests in T with an outside basis of zero and an FMV of \$3 million in exchange for their rollover interests therein. In the equity purchase, Holdco uses the \$10 million of cash to purchase interests in T from the remaining members. In the leverage purchase, Holdco distributes the proceeds of the borrowing to the members of T in redemption of all remaining outstanding interests in T (other than those held by Holdco as rollover interests). Thereafter, Holdco is owned 80% by P and 20% by the rollover members.

On the contribution of T interests by the rollover members, Holdco would become a tax partnership with two members (P and the rollover members of T), and with two assets (cash and interests in T). T (or T LLC) also would (if not already) become a tax partnership as both Holdco and the remaining members would own interests therein. The T interests contributed to P will be Section 704(c) assets on their contribution (as they will have FMV in excess of the rollover members’ basis therein). Immediately prior to its purchase of T interests held by the remaining members, Holdco will have the balance sheet shown in Exhibit 6.

Exhibit 6. Holdco's Balance Sheet

TABLETABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLEThe formation of Holdco will require that the goodwill of T be valued (as without a revaluation of T’s sole asset, no value could be determined for the T interest). [FN46]

On the purchase by Holdco of the remaining interests in T, T will become disregarded. This purchase is likely to be characterized as the conversion of T from a partnership to a [disregarded entity described in Rev. Rul. 99-6, 1999-1 CB 432](#). Under that Ruling, T will be treated as first liquidating its assets. Holdco then will be treated as purchasing those assets distributed to the remaining members in liquidation. To the extent that assets are distributed to Holdco in the deemed liquidation, Holdco will have basis in those assets equal to its basis in its T interests immediately prior to the liquidation. [FN47] Thus, immediately prior to the purchase, Holdco will receive goodwill with a value of \$3 million and basis of zero. The remaining members will receive goodwill with a value of \$20 million, which will be purchased by Holdco for \$20 million. As in Example 1, remedial allocations will be necessary to ensure that P obtains the full basis step-up allocable to its investment.

CONCLUSION

Management rollover transactions are some of the most technically complex types of acquisition transactions from a tax perspective. While the structure itself is often fairly simple, the detail and scope of tax issues that are implicated are vast. As is so often the case, the technical means by which the business arrangement of the parties is met can have signi-

ficant tax implications, and small variations in structure can, in some circumstances, translate into millions of dollars in tax benefits or detriments.

Management rollover acquisitions are not necessarily advisable in all situations. As is noted above, given the current uncertainty about the future of tax rates, it is not altogether clear that tax deferral will be advisable in all situations. Moreover, where management rolls over its interest in T on a tax-deferred basis, the acquiring entity will not obtain the benefit of a 100% step-up of the inside basis of the assets. While P remains an investor in T, this may not be problematic so long as P obtains partner-specific basis step-up to the extent that it 'pays for it' via both its equity investment and share of the debt. To the extent that rollover investments are made by private equity funds through blocker corporations, however, the lack of complete basis step-up can be problematic on exit. Typically, a fund will wish to exit an investment through a blocker corporation by selling shares of the blocker (so as to avoid corporate-level tax on a sale of interests in the portfolio company). Where a management rollover structure has been adopted, buyers of shares in the blocker will obtain only the benefit of P's partial basis step-up, and the lack of 100% basis step-up may therefore reduce the ultimate purchase price.

Notwithstanding the daunting complexity and potential pitfalls of rollover acquisitions, under the proper circumstances the use of partnership structures in management rollover transactions has the potential to retain the benefits of pass-through taxation while maximizing depreciable and amortizable basis. Whenever the purchase of a partnership or S corporation with a continued investment by management is contemplated, tax practitioners would be well advised to consider the use of a partnership or LLC to effectuate the transaction.

When properly structured, an LLC can provide significant flexibility and tax efficiency in facilitating a management rollover.

Retaining pass-through status will allow the acquiror to offer a subsequent purchaser a stepped-up basis in assets without entity-level federal income tax.

Depending on the expected appreciation of the investment and how long the sellers intend to hold their rollover interests, tax deferral may or may not be advantageous.

Structuring options to navigate the anti-churning rules will depend on T's entity type prior to the acquisition and the size of the management rollover.

When the transaction is structured via the use of a subsidiary single-member LLC, basis in the goodwill is acquired via the contribution and purchase of assets.

Care must be taken to ensure that, for purposes of characterizing T's gain on the sale of its LLC interests as long-term capital gain, T has the requisite holding period.

It may be possible to structure the transaction to take advantage of one of several safe harbors from the disguised sale presumption of the Regulations.

Savvy sellers often would be well-advised to have the traditional method applied. Buyers, by contrast, generally should insist on the remedial method.

A disconnect between inside and outside basis generally will arise where there is no 754 election in effect and a new partner acquires its interest by transfer.

1.

Practice Notes

It may be possible to create a disguised sale by having T that is a partnership form a subsidiary LLC (as is done where T is an S corporation) into which it transfers its assets and liabilities. The LLC will be a disregarded entity whose creation will not have a tax impact. The transaction then could be structured in the same manner as when T is an S corporation. That is, the equity purchase would be treated as a purchase of assets followed by a joint contribution of property to a newly formed tax partnership; and the leverage purchase would be treated as a disguised sale. So long as T owned 20% or less in the resulting tax partnership, it seems that the position could be taken that T's distributive share of the amortization deductions relating to the leverage purchase could be deducted by T's partners or members. Indeed, the argument would be no less persuasive than where T is an S corporation and structures its transaction in the same manner. Changing the structure of the transaction in this manner can thus have a significant impact where a target is subject to the anti-churning rules or where there is a disparity between inside and outside basis.

[FN1]. **MICHAEL P. SPIRO** is an associate with the Stamford law firm of Finn Dixon & Herling LLP.

[FN1]. This strategy is generally applicable to acquisitions of pass-through entities, as it permits the acquiror to continue operating the entity without interposing corporate-level federal income tax. With an S corporation, this is particularly valuable as a direct purchase of the S corporation stock by an acquisition entity would, in most instances, result in a termination of the target's S election. For private equity funds with tax-exempt or foreign investors, a blocker corporation may be interposed between the fund and the acquisition entity to avoid imposition of the unrelated business income tax under Sections 511-514 and/or tax on income effectively connected with a U.S. trade or business under Sections 871 and/or 882, as applicable. See generally Kwon, '[Exempt Entity Investments in Private Equity Funds: Blockers vs. U.S. Partnerships](#),' 109 JTAX 49 (July 2008).

[FN2]. Where a blocker structure is used, however, P typically will wish to sell interests in the blocker to avoid entity-level tax. In this situation, a subsequent purchaser will acquire only the benefit of P's basis step-up in the original transaction.

[FN3]. Section 751 .

[FN4]. Section 1374 .

[FN5]. Available at www.whitehouse.gov/omb/assets/fy2010_new_era/A_New_Era_of_Responsibility2.pdf.

[FN6]. These values are calculated using a net present value formula of: $(1 \times \text{tax rate}) / (1+r)^t$, where r is the discount rate and t is the number of years.

[FN7]. Section 197(f)(9); [Reg. 1.197-2\(h\)](#) . The restriction on amortization is not limited to the value of the goodwill on 8/10/93, and includes subsequent increases in the value of such goodwill. See Ginsburg and Levin, *Mergers, Acquisitions and Buyouts* (Aspen, Jan. 2008), ¶403.4.4.4.

[FN8]. Typically, this will be an LLC with more than one member or a limited partnership, although in rare circumstances a target business may be operated as a general partnership.

[FN9]. Section 197(f)(9); [Reg. 1.197-2\(h\)\(1\)](#) .

[FN10]. Providing a partner with basis in property distributed in liquidation equal to the partner's outside basis in its partnership interest when a Section 754 election is in effect.

[FN11]. Permitting certain transferee partners to treat a Section 754 election as having been in effect with respect to certain property distributions.

[FN12]. Providing a partnership with an adjustment to the inside basis of property to the extent that gain or loss is recognized by a partner on a distribution.

[FN13]. Providing a purchasing partner with an adjustment to its share of inside basis in partnership property on the cross-purchase of a partnership interest when a Section 754 election is in effect.

[FN14]. Management rollovers can be accomplished for S corporations without the use of an LLC (for example, by contributing S corporation stock to an acquisition entity in connection with a partial asset sale). Nevertheless, use of an LLC is the only method that this author has encountered of accomplishing a management rollover of an S corporation target that does not terminate the target's S election (and the single-layer tax benefits attendant thereto).

[FN15]. Alternatively, P may contribute cash to the LLC in exchange for interests therein. The LLC then typically would make a special distribution to T of the amount of such cash. Such a contribution and related distribution may be undertaken in order to revise the capital structure of the LLC in the easiest manner possible. The corporate simplicity afforded by such treatment could result in tax complexity, however.

[FN16]. *Rev. Rul. 99-5, 1999-1 CB 434*. If the contribution by P takes the form of a capital contribution with related distribution, the tax partnership will arise on the contribution of capital. Accordingly, the related distribution will likely be treated as a disguised sale of property to the partnership.

[FN17]. *Reg. 1.707-3(c)* .

[FN18]. *Reg. 1.707-3(a)(2)* .

[FN19]. And, as observed in note 15, *supra*, the equity purchase if structured as a contribution of cash followed by a related distribution.

[FN20]. T accordingly will recognize gain on the distribution to the extent that the amount distributed exceeds the individual asset bases of the assets contributed. Character of the gain as ordinary, short-term capital, or long-term capital will be determined on an asset-by-asset basis.

[FN21]. *Reg. 1.197-2(h)(12)(vi)(B)* .

[FN22]. *Reg. 301.7701-3* .

[FN23]. In that event, Section 742 would provide that gain recognized by P generally would be capital except to the extent allocable to certain 'hot assets' described in Section 751. Certain concerns relating to the character of capital gain as long-term or short-term is discussed in the text, below. Also, there always is some risk that the Service could challenge the characterization of the LLC as a partnership on economic substance grounds. To avoid such a challenge, it generally is advisable for the investment by T shareholders to be significant (most practitioners advise that the T shareholders invest at least 1% of total value) and the T business should be conducted by the LLC prior to the equity purchase for some substantial period (two weeks is often seen as a minimum).

[FN24]. [Reg. 1.743-1\(j\)\(1\)](#) .

[FN25]. [Reg. 1.1223-3\(b\)](#) .

[FN26]. [Reg. 1.1223-3\(b\)\(4\)](#) .

[FN27]. [Reg. 1.707-5\(b\)](#) . Where loan proceeds are distributed pro rata, no presumption of disguised sale arises.

[FN28]. This refers to P's share of the purchase price. To the extent that T bears the burden of its proportionate share of LLC debt, it will not obtain any basis step-up associated therewith.

[FN29]. For example, if in the leverage purchase the LLC intended to distribute \$10 million to T, and after the leverage purchase T was to own 25% of the LLC, P would pay to T a short-term note of \$7.5 million. This adjustment takes into account that fact that though \$10 million ultimately would be distributed to T, \$2.5 million would be debt for which T bears the economic burden.

[FN30]. As is discussed in the text, below, the application of Section 734(b) will, in most cases, have the same impact on partnership inside asset basis as does the leverage purchase under a disguised sale analysis.

[FN31]. [Reg. 1.197-2\(h\)\(12\)\(iv\)](#) .

[FN32]. [Reg. 1.197-2\(h\)\(12\)\(iv\)\(B\)](#) .

[FN33]. [Reg. 301.7701-3](#) .

[FN34]. To add further byzantine complexity to this structuring issue, it does not appear that transferring interests in T to a newly formed partnership ('Holdco') would have the same effect of creating a disguised sale. In [Rev. Rul. 84-52, 1984-1 CB 157](#), the IRS ruled that where partners of a partnership convert the partnership to a limited partnership by contributing their interests in the general partnership to a newly formed limited partnership in exchange for general and limited partnership interests, and their interests in the capital, profits, and liabilities of the entity do not change, no partnership termination occurs under Section 708 and no new partnership is created. Following this reasoning, it would appear that contributing interests in T to a Holdco in which the members of T held interests in the same proportion would not give rise to a termination of T, but instead simply would be treated as a change of T's name (as the contributed 'T' entity would become disregarded on having only one owner and would thus cease to exist for federal income tax purposes). Even if [Rev. Rul. 84-52](#) was not followed, the merger of T into Holdco would be characterized as an 'assets over' transaction in which T forms Holdco, transfers its assets and liabilities to Holdco in exchange for interests in Holdco, and immediately thereafter liquidates, transferring the interests in Holdco to its members. See [Reg. 1.708-1\(b\)\(2\)](#) (attempting to treat the contribution as an 'assets up' transaction—i.e., one in which assets were distributed to the existing members of T and re-contributed by the members of T to Holdco—would require that asset ownership actually be transferred to the members of T; see [Reg. 1.708-1\(b\)\(3\)](#)). Distributions by Holdco to its members arguably would not give rise to a disguised sale presumption, as the disguised sale presumption arises only when 'within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner'; see [Reg. 1.707-3\(c\)\(1\)](#) . In this case, for tax purposes, the assets were transferred not by the members of T, but by T itself. A distribution to the members of Holdco (who received their interests in a liquidation of T) arguably thus would not give rise to a disguised sale presumption.

[FN35]. Because debt will be incurred at the LLC level, T will bear 20% of the debt burden, reducing the actual economic transfer from P to T to \$18.4 million. Accordingly, T should agree to structure this transaction as set forth herein

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only where the aggregate value of T is \$23 million. (Of course, as a business matter, the owners of T may determine that because of the nonrecourse nature of the debt, their ‘share of the debt’ is not actually an economic cost borne by them in any real sense, in which event they may agree to this structure where the value is actually \$25 million.)

[FN36]. To the extent that P and T agree that certain of the liabilities of T will not be assumed by the new entity, those liabilities would be retained. Of course, in that event sufficient assets would have to be retained by T to avoid fraudulent transfer concerns. As is discussed in more detail in the text, below, there are many situations in which, for non-tax-related reasons, a holding upper-tier LLC will be used as the acquisition vehicle and a second-tier LLC will be used to house the operating assets.

[FN37]. It is not entirely clear that the goodwill should be trifurcated in this manner. The issue of trifurcation determines how the amortization deductions will be allocated (i.e., in accordance with the general allocation rules of Section 704(b) or under the special rules for property with book-tax disparities set forth in Section 704(c)). Under one reading of Section 704(c) , there would be one asset (goodwill) with a basis of \$20 million and a value of \$23 million. Because the Section 704(c) Regulations all require that Section 704(c) allocations be made with respect to the ‘contributing partner,’ one would have to assume that T was the ‘contributing partner’ of all of the goodwill for the unitary asset approach to work. Assuming that T was treated as the ‘contributing partner’ of the goodwill, the use of the traditional method for allocating Section 704(c) gain would result in \$18.4 million of amortization deductions being allocated to P (to match the allocation of book amortization of \$18.4 million), and no amortization allocated to T. While this approach appears far simpler and more intuitive, it is inconsistent with the characterization set forth in [Rev. Rul. 99-5, supra note 16](#) (i.e., treating the equity purchase as an asset purchase followed by a contribution), and also inconsistent with disguised sale treatment (which treats a portion of the goodwill as having been purchased from T). Accordingly, as is described in more detail in the text, below, this article assumes a separate asset approach. Also, in certain circumstances, the equity purchase may be treated, as a matter of state law, as a contribution to capital with a related distribution to T, rather than as a purchase of an interest in T. If that is so, the tax partnership will arise on the capital contribution, and the entire equity purchase and leverage purchase will be treated as being distributed in a disguised sale transaction. In those instances, there will be only two assets: LLC goodwill (equal to the full amount of the redemption proceeds) and rollover goodwill. This does not affect the analysis. As is described in more detail in the text, the only Section 704(c) asset still will be the rollover goodwill.

[FN38]. Application of the ‘traditional method with curative allocations’ described in [Reg. 1.704-3\(c\)](#) generally would have the same or similar impact in this situation as application of the remedial method. But when nonamortizable goodwill (e.g., by reason of being seller-created) that is subject to the anti-churning rules (a ‘Section 197(f)(9) intangible’) is contributed to a partnership, the Regulations permit only ‘remedial’ Section 704(c) allocations in respect of the intangible; see [Reg. 1.197-2\(h\)\(12\)\(vii\)\(B\)](#) . Accordingly, it is not at all clear that a curative Section 704(c) allocation in respect of contributed property would be permitted.

[FN39]. [Reg. 1.704-3\(b\)\(1\)](#) .

[FN40]. Where any portion of the debt is obtained from seller financing, the rules relating to the allocation of partner nonrecourse deductions set forth in [Reg. 1.704-2\(i\)](#) may cause the timing of the allocation of amortization deductions to differ. To the extent that an amortization deduction gives rise to partner minimum gain (i.e., causes the book value of the goodwill to become less than the outstanding balance on the seller note), the deduction must be allocated to T. When this partner minimum gain is subsequently reduced, however, T will be allocated a corresponding item of income as a partner minimum gain chargeback. Accordingly, while the timing of allocations may be influenced, the total amortization allocated to each of P and T over the 15-year amortization period will be as set forth in the text.

[FN41]. [Reg. 1.743-1\(j\)\(1\)](#) .

[FN42]. Because of distortions that may arise by reason of the interplay between the provisions of Section 734(b) and the capital account maintenance rules of [Reg. 1.704-1](#) (particularly the provisions of [Reg. 1.704-1\(b\)\(2\)\(iv\)\(m\)](#)), it generally is advisable for partnerships to revalue their assets pursuant to [Reg. 1.704-1\(b\)\(2\)\(iv\)\(f\)](#) when a distribution giving rise to a basis adjustment under Section 734(b) will shift the ownership percentages of the partners. See McKee, Nelson, and Whitmire, *Federal Taxation of Partners and Partnerships*, Fourth Edition (Thomson Reuters/WG&L, 2008), ¶11.02[2][c], fn. 193.

[FN43]. For example, assume that in Example 2, A, prior to the transaction, sold its interest in the LLC to C for \$150, and no Section 754 election was in effect. On the purchase, C would have basis in its partnership interest of \$150, but there would be no change to the basis of the property inside the LLC. When, after a Section 754 election is made, \$75 was distributed to C in redemption of 50% of its interest, C would recognize no gain, having sufficient basis to shelter all gain. Accordingly, there would be no amortizable adjustment under Section 734(b). Had the \$75 been distributed in a disguised sale, the asset basis would have been \$75. As discussed in the text, above, with respect to the application of the anti-churning rules, this type of situation may argue in favor of attempting to create a disguised sale through the formation of a subsidiary LLC as the target entity.

[FN44]. The business reason for this suggestion generally will relate to T's discomfort in altering its corporate structure prior to the closing of the acquisition transaction.

[FN45]. As in Example 1, debt will be incurred at the LLC level, and management will bear 20% of the debt burden, reducing the actual economic transfer from P to the members of management to \$18.4 million. Accordingly, the aggregate value of T is \$23 million.

[FN46]. [Reg. 1.704-1\(b\)\(2\)\(iv\)\(d\)\(I\)](#) . See 'AICPA Recommendations for 2002-2003 Guidance Priority List' (noting that use of a multi-tier structure can permit partnership asset revaluations where such revaluations would not otherwise be permitted under [Reg. 1.704-1\(b\)\(2\)\(iv\)\(f\)](#)).

[FN47]. Section 732(b).

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