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Deductibility of payment made in redemption of a recalcitrant partner's interest, arising in connection with a dispute

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Q: Can any part of a payment, or payments, made to settle a partners' dispute, including the redemption of a recalcitrant partner's interest, provide an ordinary current deduction for the remaining partners?

A: Yes, if the transaction is structured, and respected, as a redemption. Section 736 of the Internal Revenue Code provides that distributions made by a partnership in liquidation of a partner's interest in a partnership are categorized either as Section 736(a) payments or Section 736(b) payments. Section 736(b) payments are "payments for partnership property". Absent an agreement between the parties as to how much of the payments are Section 736(b) payments with respect to partnership property, the entire amount of such payments will be characterized as Section 736(b) payments. Generally, as long as adverse parties agree on how much of the payments are Section 736(b) payments, the balance will be characterized as Section 736(a) payments. Section 736(a) payments are treated either as the redeemed partner's "distributive share", under Section 736(a)(1), or as guaranteed payments pursuant to Section 736(a)(2), if determined without regard to partnership income. Section 736(a)(1) payments reduce the amount of partnership income that would otherwise be allocated to the remaining partners, while Section 736(a)(2) payments are deductible by the partnership.

However, while Section 736 applies to distributions made in redemption of a partner's interest, it does not apply to a purchase and sale of a partner's interest. In a transaction characterized as a purchase and sale of a partner's interest 100% of the consideration paid would be considered to be paid with respect to the acquisition of the selling partner's interest. Therefore, none of the payments would be currently deductible. If a Section 754 election is in effect then the purchasing partner, or partners, would be able to avail themselves of a Section 743(b) adjustment ("basis step-up"), generally equal to the amount by which the total consideration paid exceeds the selling partner's share of the partnership's basis in the "property". However, such an adjustment, to the extent properly allocable to depreciable property, must be depreciated over a newly assigned useful life of the "property."

As a result of the "disguised sale" rules of Section 707, the source of the cash used to redeem the partner's interest can make a difference as to whether the payments are characterized as a redemption subject to Section 736, or as a purchase and sale, to which Section 743(b) would apply. The safest and best approach would be to use cash available, and on hand, in the partnership. In such case characterization of the payment as a redemption would be pretty much a "slam dunk". Any other likely source of the cash would carry some degree of uncertainty in connection with the extent to which the Section 707 "disguised sale" rules would apply. If the cash comes from third

party debt subject to a mortgage on the partnership's property, while there is some risk, it would be very likely that the payment to the redeemed partner would be respected as a redemption. If the cash comes from a partner loan it will be more closely scrutinized. If the terms are not commercially reasonable and found to have equity characteristics, then the likelihood that the transaction is characterized as a purchase and sale is increased, significantly. If the cash comes from capital contributions of all the remaining partners, a reasonable argument may be made that the distribution should be respected as a redemption. In contrast, if the cash comes from capital contributions of fewer than all the remaining partners the transaction is pretty certain to be characterized as a purchase and sale.

Lastly, "to book-up or not to book-up"! Whenever a partner is admitted or redeemed the partnership may "revalue" its property and "book-up" all partners' capital accounts, immediately before the contemplated transaction, in accordance with Section 704. If this is done the redeemed partner's capital account will equal that portion of the amount being paid which is considered to be with respect to such partner's interest in the property. As a result, the redeemed partner's capital account will be reduced to zero. The remaining partners' capital accounts will reflect their share of the "booked-up" value of the net equity and any resulting loss caused by the 736(a)(2) payment, which is treated as a guaranteed payment deductible by the partnership, will be appropriately allocable to the remaining partners since their capital accounts will all be positive as a result of the "book-up", while the redeemed partner's capital account has been reduced to zero.

If the partnership elects not to "revalue" its property and "book-up" the capital accounts and the source of the cash is a partner loan there could be "partner minimum gain" (i.e., the amount by which the partner debt exceeds the basis of the partnership's property) and the entire loss would be required to be allocated to the lending partner. If the other remaining partners guarantee their portion of the loan, however, then they would be entitled to their proportionate share. If the partnership elects not to "revalue" and the source of the cash is a third party mortgage, then there could be "partnership minimum gain" (i.e., the amount by which the mortgage exceeds the basis of the property securing it) which normally gets allocated "pro-rata" to all partners. However, since the redemption transaction was both anticipated and imminent it must be taken into account in determining partners' "economic" capital accounts for purposes of determining income or loss allocations in accordance with Section 704(b). Therefore, the entire loss would be still be allocated to the remaining partners.

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