Forming a Partnership/LLC: A Checklist for Avoiding Pitfalls

Forming a partnership[1] without triggering income appears straightforward and simple. In many cases, it is. In other cases, though, forming a partnership can cause one or more partners to unintentionally recognize income. This Alert identifies and describes common income triggering factors and events that can arise in forming a partnership. Aware of these factors and events, businesses and their managers can avoid unintended tax consequences.

Debts and Other Liabilities

When a partner contributes property[2] to a partnership and the partnership takes the property subject to a liability or assumes a liability, it must first determine whether that transaction is a disguised sale of the contributed property (discussed below). To the extent that transaction is not a disguised sale, it must then be determined whether and to what extent the contributing partner's share of that liability declines. A partner's share of that liability is determined under special tax basis rules applying only to partnerships. If the contributing partner's share of the liability declines, the contributing partner is treated as though he received a cash distribution from the partnership. Assessing the amount and tax consequences of such a distribution requires addressing the following, among other factors:

1. Whether the contributing partner or any other partner has an economic risk of loss as to the liability;
2. If and to the extent no partner has an economic risk of loss, consider whether the contributing partner's share of the liability is affected by the fact that the asset subject to the debt has a value greater than its adjusted basis in the partnership's hands or that the amount of that debt exceeds that adjusted basis; and
3. Whether some or all of that debt/liability would be a contingent liability (e.g., environmental liabilities).

If the contributing partner is deemed to receive such a distribution, it is first applied against the contributing partner's basis in its partnership interest. If the amount of the distribution exceeds that basis, the contributing partner has gained as though it sold that interest. So, a partner recognizes gain on such a distribution only to the extent the distribution amount exceeds that partner's tax basis in its partnership interest. In a Disguised Sale, a partner may have gain even if the distribution is less than the tax basis of its partnership interest.

Disguised Sales

A disguised sale of property to a partnership is treated as a two-step transaction:

Step 1:

There is a contribution of property to the partnership in exchange for a partnership interest.

Step 2:

There is one or a series of related distributions (other than excluded distributions) from the partnership to the contributing partner.

Excluded distributions include operating cash flow distributions, preferred returns, and some capital expenditure reimbursements.[3] In addition, distributions to a partner are presumptively excluded if made two or more years apart from any contribution of property by that partner.

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Related Practice Areas

- Business
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A disguised sale can arise when a partner contributes property to a partnership, and that partnership assumes a liability of that partner or takes that property subject to a liability. In those cases, the partnership may be deemed to distribute cash to the contributing partner. Whether and to what extent such a deemed distribution is determined under directly applicable disguised sale regulations. If there is a disguised sale, the contributing partner is treated as actually selling all or a part of the contributed property.

If there is a disguised sale, and the contributed property is depreciable property, the gain on a disguised sale may be ordinary income. Such a gain would be ordinary income if the contributing partner and the partnership are related at the time the property is contributed, regardless of when the distributions are made.

Capital Shifts

A capital shift happens when one or more partners transfer some of their partnership capital to another partner. Such transfers can happen when a partnership is formed. Sometimes, partners transfer capital to compensate a partner for services. Other times, partners shift capital as part of a business deal, usually because of a capital preference (though what may appear to be such a capital shift can legitimately be treated otherwise). Sometimes, the capital shift is intentional. Sometimes, the capital shift is inadvertent. In either case, the presence or absence of a capital shift can only be determined by reviewing the terms of the partnership agreement. For this reason, partners and their counsel should carefully review partnership agreements for unintentional capital shifts.

Transfers for Services

As noted above (Capital Shifts), if a partner receives capital credit in exchange for services, that partner will recognize income. But what if the partner receives a profits interest? Many believe that a profits interest grant is nontaxable. However, the answer is more complex.

First, you must determine whether the interest is a profits interest. A profits interest is defined as an interest that, when granted, does not entitle the recipient to any share of partnership capital. An interest entitles a recipient to partnership capital if the interest would entitle the recipient to proceeds were the partnership liquidated on the grant date.

Even if the granted interest is a profits interest, the grant may still be taxable. A profits interest grant will only be nontaxable if it satisfies five tests of an IRS safe harbor rule:

1. The interest is granted for services to or for the benefit of the partnership.
2. The recipient performs those services in a partner capacity or as one anticipating that she will become a partner.
3. The interest does not relate to a certain/predictable stream of income (e.g., high-grade bond coupons).
4. The interest is held for at least two years.
5. The issuing partnership is not a publicly traded partnership.

Exercise care when dealing with profits interests. Inadvertent capital shifts on grants intended to be profits interests happen with surprising frequency. In addition, interests are sometimes granted for services that are not to or for the benefit of the partnership by a person in a partner capacity. Meeting this condition is more complex than it seems on the surface. If the condition is not met, the grant – even though a profits interest grant – will not qualify for the safe harbor rule and may trigger income.

Assets Contributed that Are Not Property

Generally, when a partner contributes property to a partnership in exchange for a partnership interest, neither the partner nor the partnership recognizes income. Sometimes a partnership

issues a partnership interest for something other than property. For example, as noted above, property does not include services. The term property also does not include a right to income from property or the right to use property. The term can include a right to acquire property. For example, the term can include rights to acquire property under a real estate purchase and sale agreement. Those rights are most likely to be property if all conditions for making the agreement binding on the seller have been satisfied. If those conditions are satisfied, that contract can have value and can be treated as property contributed for a partnership interest. In addition, a partner's promissory note can be property, though it will only result in a capital contribution as payments are made.

Related Foreign Parties

This factor is not a garden variety factor. It only arises when five conditions are satisfied:

1. a U.S. partner transfers appreciated property to a partnership (foreign or domestic)
2. a foreign person directly or indirectly owns an interest in that partnership
3. that foreign person and the transferring U.S. partner are related
4. the foreign person and the transferring U.S. partner own 80% or more of interests in partnership capital or profits
5. the built-in gain of the contributed property exceeds $1,000,000

In such cases, the transferring partner must recognize all gain on the contributed property, unless the partnership adopts the remedial allocation method[4] for the built-in gain of the transferred property. There are other exceptions as well. In any case, if the four conditions above apply, you need to address this issue.

Deemed Redemptions

Again, this is not a garden variety issue. Deemed redemptions can occur when a corporation contributes appreciated property to a partnership that owns stock (or other equity interests) of that corporation or of a corporation that the first corporation controls. In certain cases, the contributing corporate partner will be required to recognize some or all of the gain on the contributed property.

Investment Company Exception

A partner contributing property to a partnership in exchange for a partnership interest will recognize gain (if any) in the contributed property if (i) the partnership is an investment company and (ii) the contribution results, directly or indirectly, in the diversification of the partners' interests.

A partnership is generally an investment company if, immediately after the property for partnership interest exchange, more than 80% of the partnership's assets (by value) is held for investment and consists of stocks or securities (including interests in regulated investment companies or REITs).

Diversification generally occurs when two or more persons transfer nonidentical assets in forming a partnership.

Investment company exception rules seldom apply. Few partnerships are formed by partners contributing investment securities. However, in rare cases, it is necessary to wade through the very complex investment company rules to assess the risk that a partner's contribution of property will be taxable.

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[1] For this purpose, a partnership includes any entity treated as a partnership for federal income tax purposes, including a limited liability company with more than one member and has not elected to be taxed as a corporation.

[2] To be clear, property does not include cash.

[3] For a more detailed discussion on this topic, see Christopher S. McLoon, Allocating Preformation Capital Expenditure Reimbursements, *Tax Notes Federal*, March 21, 2022.

[4] The remedial allocation method is a tax accounting method specifically for contributed property with built-in gain (or loss). That method is designed to prevent shifts of tax liability (or loss benefit) from the contributing partner to other partners.