

TAX CONSEQUENCES RELATING TO THE PURCHASE AND SALE OF MEMBERSHIP INTERESTS

By: Stuart M. Bordman

I. TAXATION OF LIMITED LIABILITY COMPANIES ("LLC'S")

- A. Single member LLC'S are disregarded entities for tax purposes and the income or loss is reported on Form 1040 Schedule C or Schedule E
- B. LLC'S with more than one member are treated as partnerships for federal income tax purposes

II. BASIS

- A. Significance
 - 1. The more basis the greater the available depreciation
 - 2. The more basis the less gain upon sale
- B. Inside Basis – the basis of those assets that belong to the LLC
- C. Outside Basis – the basis each member has in his or her membership interest
- D. Inside basis equals outside basis
- E. Outside Basis equals:
 - 1. Cash or property contributed; and

2. The member's share of LLC debt

- a. An increase in debt is tantamount to a cash contribution and increases a member's basis in his membership interest (IRC §752)
- b. A decrease in debt is tantamount to a cash distribution and decreases a member's basis in his membership interest (IRC §752). (The decrease in debt is often referred to as a "deemed distribution".) If the amount of the deemed distribution exceeds the member's basis the member will recognize income to the extent of the difference

Example: A and B desire to have equal membership interests in a venture and to each contribute assets with a value of \$5,000

A contributes:

<u>Asset</u>	<u>FMV</u>	<u>Basis</u>	<u>Subject to Mortgage</u>
Land	\$25,000	\$5,000	\$20,000

B contributes cash of \$5,000

Each has contributed \$5,000. One-half of A's debt attributable to the mortgage shifts to B. The reduction in debt is a deemed distribution to A. Since A only had \$5,000 basis in his partnership interest he must recognize a gain of \$5,000 (a deemed distribution of \$10,000 less basis of \$5,000). This is an exception to the rule that contribution to an LLC and formation of an LLC is tax-free

III. SALE OF MEMBERSHIP INTEREST

- A. Generally a membership interest is a capital asset and gain or loss will be capital in nature (IRC §741)
- B. The member must know the amount of his basis in his membership interest to determine if he will have gain or loss and the amount of gain or loss upon sale of the membership interest
- C. Example: A invested \$30,000 in an LLC and became a one-third member. At the time A made the investment the LLC owed \$270,000. A's initial basis was \$120,000 (\$30,000 plus one-third of \$270,000 debt). A has taken losses of \$120,000 and today A's basis is \$0. A has found a purchaser for his membership interest who will pay \$10,000. The LLC'S debt is now \$60,000. A's proceeds from the sale will equal:

Amount from Purchaser	\$10,000
Decrease in debt (1/3 x \$60,000)	<u>20,000</u>
Total	<u>\$30,000</u>

A's gain for the sale is \$30,000. The result is consistent. The basis relating to debt when A became a member allowed him to take the losses. When A sells his membership interest the relief from his share of debt must be recognized

IV. ADJUSTMENT TO INSIDE BASIS

- A. Example: Big Sky, LLC owns vacant land that it purchased for \$30,000, but which has since increased in value and its fair market value is now \$45,000. Big Sky's balance sheet is set forth below:

<u>Land</u>	<u>Basis</u>	<u>FMV</u>
	<u>\$30,000</u>	<u>\$45,000</u>
Susan	\$10,000	
Diane	10,000	
Sandy	<u>10,000</u>	
	<u>\$30,000</u> ¹	

¹ Outside basis

Sandy sells her membership interest to Teri for one-third of the fair market value of the land, \$15,000. After this sale Big Sky's balance sheet is as follows:

	<u>Tax Basis</u>	<u>FMV</u>	<u>Capital Accounts</u>
Land	<u>\$30,000</u>	<u>\$45,000</u>	
Susan	\$10,000 ¹		\$10,000
Diane	10,000 ¹		10,000
Teri	<u>15,000</u> ¹		<u>10,000</u> ²
	<u>\$35,000</u>		<u>\$30,000</u>

¹ Outside basis

² The purchaser takes over the seller's capital account

The basis of the land is now \$5,000 less than the outside basis of \$35,000. If the LLC sold the land the day after Teri purchased her membership interest Teri would have one-third of the \$15,000 gain. This makes no sense since Teri paid \$15,000 for her membership interest

- B. IRC §754 and IRC §743 are attached to the outline. An election is made under §754 to adjust the basis of the assets under §743. After the adjustment and election the balance sheet of Big Sky is as follows:

	<u>Tax Basis</u>	<u>FMV</u>	<u>Capital Accounts</u>
Land	<u>\$35,000</u>	<u>\$45,000</u>	
Teri	\$15,000 ¹		\$10,000
Diane	10,000 ¹		10,000
Susan	<u>10,000¹</u>		<u>10,000</u>
	<u>\$35,000</u>		<u>\$30,000</u>

¹ Outside basis

- C. When Big Sky sells the land for \$45,000 it will have a gain of \$10,000. Diane and Susan will each have gains of \$5,000 and Teri will have no gain
- D. If Big Sky owned a building as well as land Teri would be entitled to additional depreciation

V. SERVICE MEMBERS

- A. Money Bags has the cash and Joe Know How is willing to put in sweat to get equity. Joe is the "service member"
- B. Nature of the interest received by the service member
 - 1. Capital
 - 2. Profits
- C. Tax Consequences
 - 1. If the service member receives a capital interest it is immediately taxable

Example: Money Bags buys land for \$10,000 and puts \$50,000 into an LLC for development of the land which will be overseen by Joe Know How in exchange for a 20% membership interest. Joe Know How has \$12,000 of taxable income (20% of

\$60,000). If the LLC were immediately liquidated Joe would receive \$12,000 but would have no gain because he has \$12,000 in basis

2. If the service member receives only a profits interest Joe Know How would only be taxed as the company has income

VI. CONVERSION FROM PARTNERSHIP TO LLC FOR PURPOSES OF SALE

A. Methods of Conversion:

1. File Bureau of Commercial Services Form 753, Articles of Organization and Certificate of Conversion (copy attached), which by operation of law will covert a partnership to a limited liability company. Pursuant to MCLA 450.4707 (copy attached) the LLC is considered the same entity as before the conversion. The LLC has all of the property rights and all of the liabilities of the former partnership. The personal liability of the partners for acts that occurred prior to conversion is not eliminated upon conversion
2. Transfer the assets of the partnership to a limited liability company and exchange the membership interest for partnership interests. The former partners become the members of the LLC

Case Study:

Big Block Partnership owns a shopping center which it desires to sell and it has found a purchaser. If Big Block sells the real estate it must pay a combined state and county transfer tax equal to .86% of the sale price. In a \$30 million sale the transfer tax would be \$258,000. In an attempt to avoid the transfer tax and to assist members of the partnership in

obtaining the benefits of Section 1031 of the Internal Revenue Code (Exchange of Property Held for Productive Use or Investment), Big Block transfers the real estate to three limited liability companies A, B and C, each of which will own an interest in the real estate as tenants in common. (A 70%, B 20%, and C 10%). Initially Big Block is the sole member of the three limited liability companies. Partners X and Y exchange their partnership interests in Big Block for membership interests in B and C. Accordingly, after the exchanges Big Block is the sole member of limited liability company A and former partners X and Y are the sole members respectively of limited liability companies B and C. Big Block, X and Y sell their respective membership interests to the purchaser. Since membership interests as opposed to real estate have been sold there has been no transfer of real estate and thus the transfer tax does not apply. This is similar to a stock sale versus an asset sale. The transaction is complicated because the sellers wish to leave no more money than is necessary in the LLC's at the date of closing.

The purchaser wants to make certain that there are no liabilities in the LLC's that are being purchased. For that reason the purchaser wants a newly formed LLC as opposed to an LLC that has been converted from a partnership and to which all pre-conversion partnership liabilities attach. Caveat: There is some question as to whether a transaction structured as set forth above will avoid the transfer tax and even if the same avoids the transfer tax today this "loophole" may be closed by legislation. It is interesting to note, however, that real estate owned within a corporation is not subject to the transfer tax. If the purchaser continues to own and operate the LLC's the

transaction will not be transitory and will have a better chance of being sustained.

Since B and C are single member LLC's (disregarded entities), X and Y can exchange their membership interests in a §1031 transactions and it's as though they exchanged real estate.

VII. DISGUISED SALE

- A. Big D owns a vacant piece of real estate. Adjacent to the vacant real estate is a strip center. Big D's plan is to organize an LLC ("Black Acre LLC") to buy the strip center with money borrowed from the bank, contribute the vacant real estate to Black Acre and have an investor, Aaron Aardvark, contribute \$750,000 to develop the vacant land as a part of the center. The last step in Big D's plan is to receive a distribution of \$250,000 from Black Acre immediately after Aardvark has made his \$500,000 cash contribution. All of the foregoing is spelled out clearly in the operating agreement. Each member will own a 50% membership interest in Black Acre. Big D's basis in the real estate is \$275,000 and its fair market value is \$600,000. What are the tax consequences of the proposed transaction to Big D, to Black Acre, LLC, and to Aaron Aardvark?

Relevant Amounts:

Big D's Basis in Vacant Real Estate	\$275,000
FMV. of Vacant Real Estate	\$600,000
Aardvark's Capital Contribution	\$750,000
Cash distribution to Big D	\$250,000

- B. As a general rule, the contribution of property to an LLC in exchange for a membership interest does not result in recognition of immediate taxable gain or loss under IRC §721(a). Since no gain or loss is recognized there is a carry-over basis in the tax attributes that are inherent in the contributed property. Thus, the tax attributes (basis

and holding period) in the contributed property immediately before the contribution are transferred to the LLC, and the unrecognized gain or loss inherent in the contributed property is reflected both in the inside basis and the contributing member's outside basis in the interest received, IRC §723

- C. When the inherent gain or loss in the property contributed is recognized, it is allocated to the contributing member. IRC §704(b), (c), and 724; Treasury Regs. §1.704-3(a)(3)(ii). This means that when Big D contributes land with a basis of \$275,000 and the land is subsequently sold for \$600,000, all of the \$325,000 gain is allocated to Big D under Section 704(c) of the Code. Alternatively, if Big D sold his membership interest for \$600,000 prior to the sale of the real estate, he would recognize gain of \$325,000 for the sale of his interest. Therefore, the operating agreement is not required to provide a special formula to allocate the gain or loss on the sale of the property to Big D. (No disguised sale)
- D, IRS §737 requires a member who receives a distribution of property within 5 years of contributing Section 704(c) property (appreciated property) to recognize gain in an amount equal to the **lesser** of (1) the remaining unrecognized Section 704(c) gain in the contributed property (\$325,000), or (2) the excess of the fair market value of the distributed property over the adjusted basis of the distributee's partnership interest. Therefore, if Big D immediately receives a distribution of \$250,000 after contributing the property to the LLC, he must recognize long-term capital gain of \$250,000
- E. In the event that Big D sold all or a portion of the vacant real estate to Aardvark prior to the transaction, Big D would recognize less gain currently, but he would have a decreased basis in his membership interest. Over time he would recognize the balance of the

unrecognized Section 704(c) gain when either the real estate or his membership interest is sold

Example:

Big D sells an undivided 41.67% of the real estate to Aardvark for fair market value \$250,000 (\$250,000 divided by \$600,000 fair market value equals 41.67%). Big D recognizes gain of \$135,416.67.

Sale Price of 41.67%

(FMV \$600,000 x 41.67%)	\$250,000.00
--------------------------	--------------

Basis (\$275,000 x 41.67%)	<u>\$114,583.33</u>
----------------------------	---------------------

Gain	\$135,416.67
------	--------------

Big D then contributes his interest in the real estate with a basis of \$160,416.67.

Basis before sale	\$275,000.00
-------------------	--------------

Basis to determine gain on sale	<u>\$114,583.33</u>
---------------------------------	---------------------

Remaining Basis	<u>\$160,416.67</u>
-----------------	---------------------

The unrecognized 704(c) gain is \$189,583.33.

FMV of R/E before sale	\$600,000.00
------------------------	--------------

FMV of R/E sold	<u>\$250,000.00</u>
-----------------	---------------------

FMV of R/E contributed	\$350,000.00
------------------------	--------------

Less Remaining Basis	<u>\$160,416.67</u>
----------------------	---------------------

	<u>\$189,583.33</u>
--	---------------------

When the real estate is sold in the future, the balance of the gain in the amount of \$189,563.33 will be recognized

- F. Under both the example and the proposed transaction, the same amount of gain is recognized. The only difference is the proposed transaction results in more of the gain being recognized sooner

	<u>EXAMPLE</u>	<u>PROPOSED</u>
Immediate Gain	\$135,416.67	\$250,000.00
Unrecognized 704(c)	<u>\$189,583.33</u>	<u>\$75,000.00</u>
Totals	<u>\$325,000.00</u>	<u>\$325,000.00</u>

- G. Although the gain recognized over time is identical under the example and the proposed transaction, Big D's basis in his interest is \$114,583.33 higher under the proposed transaction (\$275,000 minus \$160,416.67). The higher basis is preferred since Big D is entitled to receive tax free distributions equal to his basis in his membership interest in the LLC

**MICHIGAN DEPARTMENT OF CONSUMER & INDUSTRY SERVICES
BUREAU OF COMMERCIAL SERVICES**

Date Received

(FOR BUREAU USE ONLY)

This document is effective on the date filed, unless a subsequent effective date within 90 days after received date is stated in the document.

Name

Address

City

State

Zip Code

EFFECTIVE DATE:

Document will be returned to the name and address you enter above.
If left blank document will be mailed to the registered office.

ARTICLES OF ORGANIZATION AND CERTIFICATE OF CONVERSION

**For use by Domestic Partnerships or Domestic Limited Partnerships
to convert to a Domestic Limited Liability Company**

(Please read information and instructions on last page)

Pursuant to the provisions of Act 23, Public Acts of 1993, the undersigned execute the following Articles:

B

ARTICLE I

The name of the limited liability company is:

ARTICLE II

The purpose or purposes for which the limited liability company is formed is to engage in any activity within the purposes for which a limited liability company may be formed under the Limited Liability Company Act of Michigan.

ARTICLE III

The duration of the limited liability company if other than perpetual is:

ARTICLE IV

1. The street address of the location of the registered office is:

(Street Address)

(City)

Michigan

(ZIP Code)

2. The mailing address of the registered office if different than above:

(Street Address or P.O. Box)

(City)

Michigan

(ZIP Code)

3. The name of the resident agent at the registered office is:

ARTICLE V (Insert any desired additional provision authorized by the Act; attach additional pages if needed.)

Signed this _____ day of _____, _____.

By _____
(Signature)

(Type or Print Name)

CERTIFICATE OF CONVERSION

I hereby certify:

The name of the partnership or limited partnership is _____
(name)

For Partnerships only:

The partnership was formed _____
(date)

For Limited Partnerships only:

The limited partnership formed on _____ is cancelled as of the
(date)
effective date of the Articles of Organization.

(signature)

(name)

(title or capacity)

Preparer's Name _____

Business Telephone Number _____

INFORMATION AND INSTRUCTIONS

1. This form may be used to draft your Articles of Organization and Certificate of Conversion. A document required or permitted to be filed under the act cannot be filed unless it contains the minimum information required by the act. The format provided contains only minimal information required to make the document fileable and may not meet your needs. This is a legal document and agency staff cannot provide legal advice.
2. Submit one original of this document. Upon filing, the document will be added to the records of the Bureau of Commercial Services. The original will be returned your registered office address, unless you enter a different address in the box on the front of this document.

Since this document will be maintained on electronic format, it is important that the filing be legible. Documents with poor black and white contrast, or otherwise illegible, will be rejected.
3. This document is to be used pursuant to the provisions of Act 23, P.A. of 1993. **Use form C&S 753P if the limited liability company will be providing services rendered by a certified or other public accountant, a dentist, an osteopathic physician, a physician, a surgeon, a doctor of divinity or other clergy, or an attorney-at-law.**
4. Article I - The name of a domestic limited liability company is required to contain one of the following words or abbreviations: "Limited Liability Company", "L.L.C.", "L.C.", "LLC", or "LC".
5. Article II - Under section 203(b) of the Act, it is sufficient to state substantially, alone or with specifically enumerated purposes, that the limited liability company is formed to engage in any activity within the purposes for which a limited liability company may be formed under the Act.
6. Article V - Section 401 of the Act specifically states the business shall be managed by members unless the Articles of Organization state the business will be managed by managers. If the limited liability company is to be managed by managers instead of by members, insert a statement to that effect in Article V.
7. This document is effective on the date endorsed "Filed" by the Bureau. A later effective date, no more than 90 days after the date of delivery, may be stated as an additional article.
8. The Conversion must be signed on behalf of the partnership. The Articles must be signed by one person who will be a member. State name of person signing beneath their signature.
9. If more space is needed, attach additional pages. All pages should be numbered.
10. **NONREFUNDABLE FEE:** Make remittance payable to the State of Michigan. Include limited liability company name and identification number on check or money order..... **\$75.00**

To submit by mail:

Michigan Department of Consumer & Industry Services
Bureau of Commercial Services
Corporation Division
7150 Harris Drive
P.O. Box 30054
Lansing, Michigan 48909

To submit in person:

2501 Woodlake Circle
Okemos, MI 48910
(517) 241-6470

Fees may be paid by VISA or Mastercard when delivered in person to our office.

MICH-ELF (Michigan Electronic Filing System):

First time users: Call (517) 241-6420 or visit our website at <http://www.cis.state.mi.us/bcs/corp/>
Customer with MICH-ELF Filer Account: Send document to (517) 241-9845.

The Department of Consumer & Industry Services will not discriminate against any individual or group because of race sex, religion, age, national origin, color, marital status, political beliefs or disability. If you need help with reading, writing, hearing, etc., under the Americans with Disabilities Act, you may make your needs known to this agency.