

Gain on Sale of a Partnership Interest: Capital, Ordinary, or Both?

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One reasonably might expect her sale of a partnership interest to generate only capital gain; after all, a partnership interest is a capital asset.¹ While it is certainly true that overall gain from the sale of a partnership interest is determined by reference to the difference between sale proceeds and the partner's outside basis, rules under Subchapter K require "look-through" analysis of the character of the partnership's assets on the date of sale to properly allocate the seller's overall gain or loss between "buckets" of ordinary income and capital gain.²

So, how must a seller determine the character of gain or loss from the sale of a partnership interest?³ The first step is to identify ordinary income-producing properties held by the partnership on the date of the sale of the partnership interest.⁴ Next, the seller must determine her share of gain from a hypothetical sale of those ordinary income-producing properties.⁵ Finally, the selling partner subtracts her share of gain⁶ upon a hypothetical sale of ordinary income-producing properties from the seller's

¹ Internal Revenue Code §741 and §743(a) appears to operate to characterize gain (or loss) on sale of the partnership interest under an entity-level approach.

² IRC Section 741 provides that the character of a gain from the sale or exchange of a partnership interest will constitute the sale or exchange of a capital asset, except as re-characterized as ordinary income under §751.

³ As of the date of this writing, income tax rates applicable to ordinary income may be as high as 39.6% whereas under IRC §1(h), capital gains rates can range from 28% (on collectibles) 25% on §1250 gain and 15% on all other capital gains. Thus, current tax law continues to provide meaningful tax-incentive for preservation of capital gains.

⁴ Section 751(a) provides that two types of properties, so-called "unrealized receivables" and so-called "inventory items," give rise to ordinary income. Unrealized receivables include recapture items, in addition to uncollected receivables from the sale of goods and services of a cash-basis taxpayer. Under §751(d)(3), "inventory items" include property which would be inventory, if held by the selling partner.

⁵ Proposed regulation §751-1(a)(2) describes the mechanical procedure for this calculation.

⁶ Note: IRC §704(c)(1)(A) requires that income, gain, loss, and deduction of property contributed to the partnership by a partner must be shared among the partners so as to take into account built-in gain or loss on the date of contribution of the property to the partnership.

overall gain; the difference is the amount of gain or loss which retains capital gain character.⁷

Stated succinctly, this article highlights a significant, yet often over-looked, federal income tax consideration for the seller of a partnership interest:

All gain (or loss) realized on the sale of a partnership interest in an operating business is not likely entirely capital in character. What is more likely, is that some, all, or more than all of the gain, is properly characterized as ordinary.⁸

Important implications flow from cognizance that sale of a partnership interest may produce ordinary income and heightened current tax costs. For example, when negotiating terms of installment payments for a partnership interest, the seller may consider that installment gain treatment is generally not available for gains from ordinary income items such as the sale of inventory, certain accounts receivable, recapture items, and securities traded on an established exchange.⁹ A seller also may wish to defray current tax costs by considering that the buyer will want a step-up in basis in underlying assets represented by her acquired partnership interest; the buyer may be willing to pay a premium to obtain the selling partner's consent to a partnership-level election, a necessity to the buyer's inside basis step-up.¹⁰ Finally, a seller may consider that although, in form, she sells a partnership interest, the hypothetical gain or

⁷ Proposed regulation §1.751-1(a)(2).

⁸ As if to add insult to injury, it is conceivable that the seller of a partnership interest could realize ordinary income in excess of the overall gain upon which she must pay income tax currently, while incurring a non-deductible capital loss.

⁹ IRC §453(k)(2)(A) and (B).

¹⁰ When a partnership makes an IRC §754 election, an adjustment prescribed by IRC §743(b) is made for an amount equal to the difference between the buyer's outside basis and her share of inside basis. Tax provisions of the partnership agreement should be consulted to determine which of the partners possess the right to make the §754 election.

loss calculation on partnership-level assets may drive the need for, and cost of, a fair value appraisal of underlying partnership assets.

In summary, federal tax rules require the seller of a partnership interest to determine the ordinary and capital character of gain or loss upon sale. The ultimate character of the seller's gain is determined by analyzing the character of underlying partnership assets, as represented by the seller's partnership interest. By gaining a solid understanding of ordinary and capital characters of gain or loss in advance of a proposed partnership interest transaction, an informed seller is better-equipped to quantify the tax costs associated with a proposed transaction. A seller, informed in advance of tax consequences of the proposed transaction, is also better positioned to negotiate payment terms, negotiate terms of consent to potential partnership-level elections, and ultimately to maximize her partnership interest offering price.