

Section 708.—Continuation of Partnership

26 CFR 1.708-1: Continuation of partnership. (Also sections 731, 732, 735, 741, 751, 1012; 1.741-1; 301.7701-2, 301.7701-3.)

Partnership to disregarded entity.

This ruling describes the federal income tax consequences if one person purchases all of the ownership interests in a domestic limited liability company (LLC) that is classified as a partnership under section 301.7701-3 of the Procedure and Administration Regulations, causing the LLC's status as a partnership to terminate under section 708(b)(1)(A) of the Code.

Rev. Rul. 99-6

ISSUE

What are the federal income tax consequences if one person purchases all of the ownership interests in a domestic limited liability company (LLC) that is classified as a partnership under § 301.7701-3 of the Procedure and Administration Regulations, causing the LLC's status as a partnership to terminate under § 708(b)(1)(A) of the Internal Revenue Code?

FACTS

In each of the following situations, an LLC is formed and operates in a state which permits an LLC to have a single owner. Each LLC is classified as a partnership under § 301.7701-3. Neither of the LLCs holds any unrealized receivables or substantially appreciated inventory for purposes of § 751(b). For the sake of simplicity, it is assumed that neither LLC is liable for any indebtedness, nor are the assets of the LLCs subject to any indebtedness.

Situation 1. A and B are equal partners in AB, an LLC. A sells A's entire interest in AB to B for \$10,000. After the sale, the business is continued by the LLC, which is owned solely by B.

Situation 2. C and D are equal partners in CD, an LLC. C and D sell their entire interests in CD to E, an unrelated person, in exchange for \$10,000 each. After the sale, the business is continued by the LLC, which is owned solely by E.

After the sale, in both situations, no entity classification election is made under § 301.7701-3(c) to treat the LLC as an association for federal tax purposes.

LAW

Section 708(b)(1)(A) and § 1.708-1(b)(1) of the Income Tax Regulations provide that a partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Section 731(a)(1) provides that, in the case of a distribution by a partnership to a partner, gain is not recognized to the partner except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.

Section 731(a)(2) provides that, in the case of a distribution by a partnership in liquidation of a partner's interest in a partnership where no property other than money, unrealized receivables (as defined in § 751(c)), and inventory (as defined in § 751(d)(2)) is distributed to the partner, loss is recognized to the extent of the excess of the adjusted basis of the partner's interest in the partnership over the sum of (A) any money distributed, and (B) the basis to the distributee, as determined under § 732, of any unrealized receivables and inventory.

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of the partner's interest in the partnership, reduced by any money distributed in the same transaction.

Section 735(b) provides that, in determining the period for which a partner has

held property received in a distribution from a partnership (other than for purposes of § 735(a)(2)), there shall be included the holding period of the partnership, as determined under § 1223, with respect to the property.

Section 741 provides that gain or loss resulting from the sale or exchange of an interest in a partnership shall be recognized by the transferor partner, and that the gain or loss shall be considered as gain or loss from a capital asset, except as provided in § 751 (relating to unrealized receivables and inventory items).

Section 1.741-1(b) provides that § 741 applies to the transferor partner in a two-person partnership when one partner sells a partnership interest to the other partner, and to all the members of a partnership when they sell their interests to one or more persons outside the partnership.

Section 301.7701-2(c)(1) provides that, for federal tax purposes, the term "partnership" means a business entity (as the term is defined in § 301.7701-2(a)) that is not a corporation and that has at least two members.

In *Edwin E. McCauslen v. Commissioner*, 45 T.C. 588 (1966), one partner in an equal, two-person partnership died, and his partnership interest was purchased from his estate by the remaining partner. The purchase caused a termination of the partnership under § 708(b)(1)(A). The Tax Court held that the surviving partner did not purchase the deceased partner's interest in the partnership, but that the surviving partner purchased the partnership assets attributable to the interest. As a result, the surviving partner was not permitted to succeed to the partnership's holding period with respect to these assets.

Rev. Rul. 67-65, 1967-1 C.B. 168, also considered the purchase of a deceased partner's interest by the other partner in a two-person partnership. The Service ruled that, for the purpose of determining the purchaser's holding period in the assets attributable to the deceased partner's interest, the purchaser should treat the transaction as a purchase of the assets attributable to the interest. Accordingly, the purchaser was not permitted to succeed to the partnership's holding period with respect to these assets. See also Rev. Rul. 55-68, 1955-1 C.B. 372.

ANALYSIS AND HOLDINGS

Situation 1. The AB partnership terminates under § 708(b)(1)(A) when B purchases A's entire interest in AB. Accordingly, A must treat the transaction as the sale of a partnership interest. Reg. § 1.741-1(b). A must report gain or loss, if any, resulting from the sale of A's partnership interest in accordance with § 741.

Under the analysis of *McCauslen* and Rev. Rul. 67-65, for purposes of determining the tax treatment of B, the AB partnership is deemed to make a liquidating distribution of all of its assets to A and B, and following this distribution, B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A's partnership interest.

B's basis in the assets attributable to A's one-half interest in the partnership is \$10,000, the purchase price for A's partnership interest. Section 1012. Section 735(b) does not apply with respect to the assets B is deemed to have purchased from A. Therefore, B's holding period for these assets begins on the day immediately following the date of the sale. See Rev. Rul. 66-7, 1966-1 C.B. 188, which provides that the holding period of an asset is computed by excluding the date on which the asset is acquired.

Upon the termination of AB, B is considered to receive a distribution of those assets attributable to B's former interest in AB. B must recognize gain or loss, if any, on the deemed distribution of the assets to the extent required by § 731(a). B's basis in the assets received in the deemed liquidation of B's partnership interest is determined under § 732(b). Under § 735(b), B's holding period for the assets attributable to B's one-half interest in AB includes the partnership's holding period for such assets (except for purposes of § 735(a)(2)).

Situation 2. The CD partnership terminates under § 708(b)(1)(A) when E purchases the entire interests of C and D in CD. C and D must report gain or loss, if any, resulting from the sale of their partnership interests in accordance with § 741.

For purposes of classifying the acquisition by E, the CD partnership is deemed to make a liquidating distribution of its assets to C and D. Immediately following

this distribution, *E* is deemed to acquire, by purchase, all of the former partnership's assets. Compare Rev. Rul. 84-111, 1984-2 C.B. 88 (Situation 3), which determines the tax consequences to a corporate transferee of all interests in a partnership in a manner consistent with *McCauslen*, and holds that the transferee's basis in the assets received equals the basis of the partnership interests, allocated among the assets in accordance with § 732(c).

E's basis in the assets is \$20,000 under § 1012. *E*'s holding period for the assets begins on the day immediately following the date of sale.

DRAFTING INFORMATION

The principal author of this revenue ruling is Matthew Lay of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling contact Mr. Lay at (202) 622-3050 (not a toll-free call).