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"Hot" Partnership Assets and Installment Sales

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Installment Reporting — Sale of Corporate Stock v. Sale of Partnership Interest

Most advisers understand that if a taxpayer sells his or her shares of stock in a corporation in exchange for a promissory note, the taxpayer can generally defer recognition of the gain realized on the sale until principal payments are received on the note ("installment reporting").

Although installment reporting is subject to various limitations (for example, the note cannot be a demand note, and the seller cannot be a dealer in securities), the composition of the corporation's assets does not, generally speaking, affect either the nature of the gain (as capital or ordinary) arising from the sale of the stock, or the timing of its recognition.

Many advisers assume that the same tax treatment applies to the sale of an interest in a partnership or LLC. The Code [741] provides that, in the case of a sale of a partnership interest, the gain recognized to the selling partner shall be treated as gain from the sale of a capital asset, which should qualify for installment reporting. However, the code goes on to provide that any consideration received by the selling partner that is attributable to the seller's share of the unrealized receivables or inventory items ("so-called "hot assets") of the partnership shall be treated as ordinary income. [751]

Assets Excluded from Installment Reporting

The installment method of reporting is not available for the sale of certain types of assets, including (among others) marketable securities, depreciation recapture, inventory, and unrealized receivables.

IRS's Position re Hot Assets

The IRS has long taken the position that the gain from the sale of a partnership interest is not eligible for installment reporting to the extent of the selling partner's pro rata share of the partnership's "hot assets."


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Until recently, there did not appear to be any direct judicial support for the IRTS's position. The Fifth Circuit's decision in *Mingo v. Comr.,* No. 13-60801 (5th Cir. 2014), earlier this month, affirmed the Tax Court and, thereby, provided the necessary support.

Tax Court and Fifth Circuit Join the IRS

The Facts

Taxpayer was a partner in firm's management consulting business ("consulting business") until tax year 2002, when firm sold its consulting business to corp.

As an initial step in the transaction, partnership LP was formed in early 2002. It was owned by certain subsidiaries of firm. As part of the transaction, firm transferred its consulting business to LP. Among the assets firm transferred to LP were its consulting business's uncollected accounts receivable for services it had previously rendered. Firm then transferred to each of the consulting partners, including taxpayer, an interest in LP and cash in exchange for the partner's interest in firm. The value of taxpayer's partnership interest in LP as of October 2002, was $832,090, of which $126,240 was attributable to her interest in firm's unrealized receivables. On that date, firm caused its subsidiaries to sell their respective interests in LP to corp. At the same time, the consulting partners sold their respective interests in LP to corp in exchange for convertible promissory notes. At the end of the transaction, corp owned 100 percent of the consulting business.

Corp gave taxpayer a convertible promissory note for $832,090 in exchange for her interest in LP. The $126,240 attributable to her interest in partnership unrealized receivables was included in that face value. The note provided that, unless the note was converted into corp stock, corp would pay interest on the unpaid principal balance semiannually; and the outstanding principal amount of the note and any accrued and unpaid interest was due and payable on the fifth anniversary of the transaction's closing (i.e., October 1, 2007).

Taxpayer's Return

On her 2002 Federal income tax return, taxpayer reported the sale of her partnership interest in LP as an installment sale. The selling price, gross profit, and contract price were listed as $832,090. Taxpayer did not recognize any income relating to the note, other than interest income.

The IRS issued a notice of deficiency, contending that the $126,240 taxpayer had received in exchange for the partnership's unrealized receivables was not eligible for reporting under the installment method. Accordingly, the IRS concluded that taxpayer should have reported this amount as ordinary income in 2002 and paid taxes on it then.

Taxpayer challenged both of the IRS's deficiency determinations before the Tax Court. The central dispute raised by taxpayer was the legal question of whether the installment method can be used to report the portion of the partnership interest attributable to unrealized receivables, given its status as ordinary income.

The Tax Court

The Tax Court found in favor of the IRS, stating that "the gain realized on [taxpayer's] partnership interest, to the extent attributable to partnership unrealized receivables, was . . . ineligible for installment method reporting." Accordingly, the Tax Court concluded that taxpayer should have properly reported an additional $126,240 of ordinary income on her 2002 Federal income tax return instead of reporting it under the installment method.

The Court of Appeals

The Fifth Circuit reviewed the relevant provisions of the code. It noted that the Code [Section 741] specifically provides that gain from the sale of a partnership interest shall ordinarily be considered gain from the sale or exchange of a capital asset, with some exceptions. Those exceptions include gain from unrealized receivables. [Section 751] The court stated that the gain resulting from the unrealized receivables on the sale of a partnership interest should not be reported as gain from the sale or exchange of a capital asset. Because the gain from the sale of taxpayer's partnership interest attributable to unrealized receivables could not be reported as gain from a capital asset, the court continued, it was required to be reported as gain from ordinary income. The purpose of this exception, the court said, is to prohibit the transformation of ordinary income, arising from services, into capital gain (which is taxed more favorably) simply by being passed through a partnership and sold.

Thus, the court concluded that the gain attributable to the unrealized receivables — classified as ordinary income — was not eligible for installment method reporting because it did not arise from the sale of property. The installment method did not adequately reflect the income that taxpayer received from the unrealized receivables.

Planning for A Sale

Every sale transaction is about

economics. In analyzing the economic results of a sale, the seller and his or her advisors need to consider the impact of taxes. The nature of the sale gain as ordinary or capital, and the timing of its recognition – either immediately, or over time under the installment method – will determine the tax consequences of the sale.

Where the seller has agreed, for valid business reasons, to accept an installment note in exchange for the partnership interest being sold, he or she has presumably considered the credit risk associated with the deferred payment of the sale price. An appropriate interest rate and collateral will make the seller more comfortable with the arrangement.

However, the seller also has to consider the nature of the partnership's underlying assets. Where the assets include unrealized receivables, based on the foregoing discussion, the seller may be facing phantom income – the inclusion, in the year of the sale, of the value attributable to the receivables notwithstanding the deferral of the buyer's payment therefore. (The same seems to be true in the case of depreciation recapture; it may also be true as to other partnership assets not eligible for installment reporting.)

It is imperative, therefore, that the seller of a partnership interest ascertain his or her share of such receivables, and the value thereof, well before the sale. Armed with this information, the seller may, for example, be able to negotiate a cash payment up-front, so as to provide sufficient liquidity with which to pay any resulting income taxes. (Query whether it may be possible to allocate this cash payment to that portion of the partnership interest that does not qualify for installment reporting?)

With the necessary information and some planning, a seller can avoid the surprise that befell the taxpayer in *Mingo,* and can thereby preserve the desired economic result of the transaction.

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