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TAX LAW ALERT

June 2013

Wild Results With Revenue Ruling 99-6[1]

A lot has been written about two simple, straight-forward fact patterns set forth in Internal Revenue Service Revenue Ruling 99-6. Like most guidance from the Service, the devil is in the details as we were reminded once again last month.

In the Ruling, the first scenario examines what happens when a 50/50 limited liability company taxed as a partnership, AB, LLC, becomes a disregarded entity upon A's sale of his entire interest to B for $10,000. In the second scenario, equal members/partners C and D sell their entire interests in CD, LLC to E, an unrelated person, in exchange for $20,000 ($10,000 each). Under both scenarios, no entity classification elections are made to treat either limited liability company as an association taxable as a corporation. Applying the analysis of these two scenarios to a proposed transaction reviewed by our office shows that the structuring of the transaction can result in wildly different tax results.

In our proposed transaction, Dad holds an 80% interest and his four sons each own a 5% interest in Father & Sons, LLC, a limited liability company taxed as a partnership (the "LLC"). Dad has an adjusted basis in his interest in the LLC of $60. The LLC has the following assets on its books: Cash ($10); Inventory ($13); Intangible Assets ($50); and Depreciable Assets ($17). The LLC is also carrying on its books Accumulated Depreciation and Amortization ($10).

Dad is approached by Buyer who wants to purchase the assets of the LLC for $100. For purposes of simplifying arrangements with Buyer, Dad wants to purchase the minority interests directly from his sons for a total of $20 ($5 each), and then move forward with the sale of the LLC's assets.

Pursuant to the first scenario, everything is predicated upon Dad's adjusted basis of his interest in the LLC. Dad's purchase of his sons' membership interests is treated as a "deemed liquidation" of the LLC assets, with the value of those assets equal to the sum of Dad's existing adjusted basis of $60 and the aggregate sales price paid to his sons of $20. Dad's revised adjusted basis is $80, from which his proportionate share of the cash paid to sons ($16, representing Dad's 80% interest in the $20) needs to be deducted. So for purposes of determining gain on the transaction, Dad would recognize a gain of $36 (the difference between the Buyer's $100 purchase price and Dad's revised adjusted basis of $64).

Under the second scenario, everything is predicated upon the basis of the assets in the LLC. In this case, the gain is equal to the difference between the Buyer's purchase price and the adjusted basis of the LLC's assets. The adjusted basis in the LLC's assets is equal to the sum of its existing assets, $90, *less* Accumulated Depreciation and Amortization of $10. This results in an adjusted basis in the LLC's assets of $80. So for purposes of determining the gain on the transaction, the difference between the Buyer's purchase price and adjusted basis of the LLC's assets is $20, of which $16 is allocated to Dad.

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[1] 1999-1 C.B. 423

Under either scenario, when the transaction with the Buyer is done Dad will have $80 in cash prior to taxes ($100 from the Buyer less the $20 paid to the sons or 80% of the $100 from the Buyer). The income tax difference to Dad is 100% of the $36 in gain versus 80% of the $20. Obviously the numbers and capital structure have been simplified, but the magnitude of the difference (more than twice the taxable gain if the sale is preceded by buying out the sons) remains. Wild results, indeed, and all in the name of simplicity.

Upcoming Speaking Engagements

Monday, June 17, 2013

Christopher J. Rixon, a member of the firm's Business Law Practice Area and chair of the firm's Tax Group, will present at the Connecticut Bar Association's Annual Meeting in Hartford, Connecticut. He will discuss the individual income tax and business tax changes enacted by the passage of the American Taxpayer Relief Act of 2012.

Wednesday, June 26, 2013

John M. Horak and Edward B. Spinella, members of the firm's Business Law and Nonprofit Organizations Practice Areas, will present at The Not-for-Profit Organizations Conference, hosted by the Connecticut Society of Certified Public Accountants. They will discuss the elements of unrelated business income, including the statute, cases and rulings. John will discuss the Internal Revenue Code and ERISA requirements that apply to Section 403(b) plans as well as some of the common defects that arise in the operation and administration of Section 403(b) plans.

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This issue of the Tax Law Alert was written by Christopher J. Rixon, Chair of the Tax Group at Reid and Riege, P.C. The Group works with business lawyers on issues of choices of entities, formation and operation, as well as taxable and/or tax-free transactions. The Group is involved with decisions involving capitalization, working with commercial and transactional lawyers in structuring and determining levels of equity, debt and various hybrids. The Tax Group is also called upon to work outside the Business Law Practice Area with respect to issues of pensions and profit sharing arrangements, trusts and estates, personal wealth planning, real estate transactions and financing, litigation and settlement agreements, health care and nonprofit law.

For information or additional copies of this newsletter, or to be placed on our mailing list, please contact Carrie L. Samperi at (860) 240-1008 or info@rrlawpc.com, or members of Reid and Riege, P.C., One Financial Plaza, Hartford, CT 06103. For other information regarding Reid and Riege, P.C., please visit our website at www.rrlawpc.com.

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