

Tax Aspects of Buy-Sells

Business Owner Buyouts

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March 01, 2017



Updated March, 2017

This outline summarizes very generally certain of the federal income tax aspects of buying an owner (the “retiring shareholder” or “retiring partner,” as the case may be) out of a business operated in the form of an entity classified for tax purposes as a corporation, on the one hand, or a partnership, on the other.¹

I. Redemption (Purchase by Entity)²

a. Corporation.

1. Retiring shareholder. The tax consequences of the redemption to the retiring shareholder are generally determined under Internal Revenue Code (“Code”) Section 302. A complete termination of the retiring shareholder’s interest in the corporation in a single transaction generally results in the retiring shareholder being treated as having sold his or her shares, with the retiring shareholder having gain or loss (capital if the retiring shareholder held his or her shares as a capital asset, and long-term if the retiring shareholder held the shares for more than a year) equal to any difference between the amount he or she realizes in the redemption and his or her share basis.³ A redemption payment to a retiring shareholder is treated as a distribution to the retiring shareholder with respect to his or her shares (and not in exchange for the shares), however, if the redemption does not satisfy any of the Section 302(b) tests (because, for example, the retiring shareholder continues to own too many shares, actually or by attribution, after the redemption).⁴

2. Corporation. Redemption payments (at least principal payments) are non-deductible (Code Section 162(k)). A redemption of a shareholder’s shares has no effect on the corporation’s basis in its assets.

3. Remaining shareholders. The remaining shareholders generally have no income unless they had the primary obligation to purchase the shares of the retiring shareholder, in which case the corporation’s payments to the retiring shareholder are deemed to be distributed to the remaining shareholders, who are then deemed to use the amounts to buy out the retiring shareholder.⁵ The remaining shareholders can also be deemed to receive taxable stock distributions under Code Section 305 if the redemptions are part of a periodic redemption plan having the effect of the receipt of money or other property by the retiring shareholders (in distributions to which Section 301 applies) and an increase in the interests of the remaining shareholders in the assets or earnings and profits of the corporation.

b. Partnership.⁶

1. Retiring partner. The tax consequences of the redemption to the retiring partner are determined under Code Sections 736, 751(b) and 731 and 741 (and can be complicated). The amount paid to the retiring partner is deemed to include any reduction in his or her share of the partnership's debt.

A. *Section 736.* Section 736(b) provides that a payment by a partnership to a partner in liquidation of the partner's interest in the partnership is treated as a distribution by the partnership to the partner to the extent the payment is made in exchange for the partner's interest in partnership property. Any portion of the payment that is so treated as a distribution is then directed on to Sections 751(b), 731 and 741 (see below). Payments made by a partnership to a retiring partner that are not made in exchange for the retiring partner's interest in partnership property are treated, under Section 736(a), as "distributive shares" of partnership income if determined with regard to the income of the partnership or as "guaranteed payments" if they are determined without regard to the income of the partnership. Any such distributive share allocations and guaranteed payments are generally reportable by the retiring partner as ordinary income. If "capital is not a material income producing factor" for the partnership (i.e., the partnership is a service partnership) and the retiring partner is a "general partner," amounts treated as distributive shares or guaranteed payments under Section 736(a) include amounts paid to the retiring partner for his or her interest in (i) any "unrealized receivables" of the partnership (which exclude, for purposes of Section 736, depreciation recapture and certain other items that are included in the definition for purposes of applying Sections 751(a) and 751(b)) and (ii) any goodwill of the partnership in excess of the partnership's basis in the goodwill) except to the extent that the partnership agreement provides for a payment with respect to goodwill.⁷

B. *Section 751(b).* To the extent that any amount paid to the retiring partner and treated as a distribution (rather than a distributive share or guaranteed payment) by Section 736 is in exchange for the retiring partner's interest in the partnership's unrealized receivables (including, among other things, recapture inherent in any depreciable/amortizable property) or "substantially appreciated" (value in excess of 120% of adjusted basis) "inventory" (which includes, in addition to traditional inventory, property income from the sale of which would be ordinary), the retiring partner is required by Section 751(b) to recognize his or her share of the ordinary income inherent in those partnership assets. Under the regulations currently in effect, the retiring partner is deemed to (i) receive the share of the unrealized receivables or substantially appreciated inventory for which he or she is being paid cash in a non-liquidating distribution from the partnership (taking a basis in the distributed unrealized receivables or substantially appreciated inventory equal to the lesser of the partnership's basis in those assets or his or her basis in his or her interest in the partnership) and then (ii) sell the distributed unrealized receivables or substantially appreciated inventory back to the partnership for the cash he or she is being paid for his or her interest in them. The deemed sale generates ordinary income for the retiring partner to the extent of any excess of the cash payment he or she is deemed to receive for the unrealized receivables or inventory over the basis he or she took in those assets.⁸

C. *Sections 731 and 741.* Any amount that is paid to the retiring partner, treated as a distribution (rather than a distributive share or guaranteed payment) by Section 736 and not deemed to have been paid to the retiring partner for unrealized receivables or substantially appreciated inventory in a deemed sale back to the partnership under Section 751(b) produces gain (or loss) for the retiring partner under Sections 731 and 741 (capital if the retiring partner held his or her interest in the partnership as a capital asset, and long-term if the retiring partner held the

interest for more than a year) to the extent such amount exceeds (or is less than) the retiring partner's basis in his or her interest in the partnership as of the time immediately before the distribution.⁹ For purposes of determining the amount of any such gain or loss, the retiring partner's basis excludes the basis he or she was deemed to take in any unrealized receivables or substantially appreciated inventory that were deemed to have been distributed to him or her and sold back to the partnership under Section 751(b).¹⁰

2. Partnership. Amounts treated as guaranteed payments to the retiring partner under Section 736(a) are generally deductible expenses for the partnership. Amounts treated as distributive shares of partnership income to the retiring partner under Section 736(a) generally have the effect to the remaining partners of deductible expenses because they (the remaining partners) would otherwise have to report the distributive share amounts. The partnership's basis in any unrealized receivables or inventory it is deemed to distribute to, and repurchase from, the retiring partner under Section 751(b) is adjusted to the amount of the deemed repurchase price.¹¹ In addition, if the partnership has an election under Code Section 754 in effect, the partnership increases (or reduces) its asset basis by the amount of any gain (or loss) recognized by the retiring partner under Section 731.¹²

3. Remaining partners. Because the profits and losses (and the component items of income, gain, loss and deduction) of a partnership are reported by its partners, the remaining partners get the benefit of their shares of the amounts paid to the retiring partner that are deductible as guaranteed payments or treated as distributive shares of the partnership's income. Any amounts by which the partnership can increase its bases in any of its assets will also inure, ultimately, to the benefit of the remaining partners. The remaining partners can have deemed distributions themselves, though, if their shares of any partnership debt are reduced or if they had the primary obligation to purchase the interest of the retiring partner.

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Footnotes.

1. Entities classified as partnerships for tax purposes include limited liability companies ("LLCs"), limited partnerships, limited liability partnerships and general partnerships (so long, in each case, as they have more than one owner and that have not elected to be classified as corporations).

2. It is assumed in this Section I. that any redemption is of entire interest of the retiring shareholder or retiring partner, as the case may be, for cash.

3. It should be noted that the attribution rules of Code Section 318 prevent the redemption of a retiring shareholder's shares from being a complete termination under Code Section 302(b)(3) if the retiring shareholder is deemed to own any shares held by remaining shareholders.

4. The tax consequences of a redemption payment that does not satisfy any of the Section 302(b) tests are generally determined under Code Section 301, if the corporation is a C corporation, or Code Section 1368, if the corporation is an S corporation. If the corporation is a C corporation, a redemption payment to a shareholder that is not treated as a payment in exchange for the shareholder's shares is a dividend to the extent of the corporation's current or accumulated earnings and profits (without any offset by the shareholder's basis in the redeemed shares).

5. Rev. Rul. 69-608, 1969-2 C.B. 42.

6. It is assumed in this Section I.b. and in Section II.b., after the redemption or purchase of the retiring partner's interest, the partnership has at least two remaining partners. See Section V. for a discussion of the applicability of the buy-sell rules to two-person partnerships.

7. Payments treated as distributive shares or guaranteed payments under Section 736(a) can also include amounts paid to the retiring partner in lieu of interest and amounts paid to the retiring partner in the nature of mutual insurance.

8. The current regulations require that each partner's interest in the gross value of each partnership asset be determined to measure whether any portion of the cash distribution to the retiring partner is in exchange for an interest of the retiring partner in the partnership's unrealized receivables or substantially appreciated inventory. Proposed regulations published in November of 2014 would, when finalized, value the partnership's assets at fair market value for purposes of determining the applicability of Section 751(b) and allow the partnership to determine the tax consequences of any distribution to which Section 751(b) applies using a reasonable approach adopted by the partnership consistent with the purposes of Section 751(b). Under the proposed regulations, Section 751(b) would apply to a cash distribution by a partnership in redemption of a retiring partner's interest if the distribution would reduce the retiring partner's "net Section 751 unrealized gain" with respect to the partnership (such a reduction would be referred to as the retiring partner's "Section 751(b) amount"). The retiring partner would have such a reduction to the extent of any net income that would have been allocated to him or her with respect to the partnership's unrealized receivables and substantially appreciated inventory if the partnership had sold its assets at fair market value (in the case of any asset subject to nonrecourse debt, not less than the amount of the debt) as of the time immediately before his or her redemptive distribution. If the distribution to the retiring partner would cause such a reduction, the consequences of the distribution would have to be determined under a reasonable approach adopted by the partnership consistent with the purposes of Section 751(b). The reasonable approaches could include a deemed allocation of unrealized ordinary income to the retiring partner (with corresponding increases in the retiring partner's basis in his or her interest in the partnership and in the partnership's basis in its unrealized receivables and substantially appreciated inventory) or a deemed distribution and sale-back like the one constructed by the current regulations.

9. Note that it is possible for the retiring partner to recognize both ordinary income and capital loss on the redemption of his or her interest. It is also possible for the retiring partner to recognize ordinary income in the Section 751(a) component of the transaction even if the retiring partner has an overall realized loss on the sale.

10. If, after the finalization of the proposed Section 751(b) regulations discussed in footnote 8, the retiring partner is allocated unrealized ordinary income with respect to any unrealized receivables or substantially appreciated inventory of the partnership, his or her adjusted basis will be increased by the amount of income so allocated to him or her for purposes of determining the amount of any capital gain or loss he or she has on the portion of the distribution governed by Section 731.

11. If, under the proposed Section 751(b) regulations discussed in footnote 8, the retiring partner is allocated unrealized ordinary income with respect to any unrealized receivables or substantially appreciated inventory of the partnership, the partnership's adjusted basis in the unrealized receivables or substantially appreciated inventory will be increased by the amount of income so allocated to the retiring partner.

12. If 50% or more of the interests in a partnership's capital and profits are sold within a period of twelve months, the partnership terminates for tax purposes under Code Section 708(b)(1)(B). For purposes of the termination rule, the liquidation of an interest in the partnership is not treated as a sale. See Regulations Section 1.708-1(b)(2).

