

Law Firm Break-Up and Retirement: Breaking Up is Hard to Do Part I

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PRELIMINARY REVIEW

- Entity Structure
- Corporation
 - Dividend; Split-up
 - Purchase & Sale
- Partnership
 - More Structural Flexibility
 - Tax Complexity – Planning Options

CORP. SALE v. REDEMPTION

- Usually purchase/sale of shares
 - “Consulting Agreement”
 - Reasonable Compensation Issues
 - Cross Purchase/Redemption
- S Corporation Consider AAA
 - Basis - Moving Target (Form 7203)
 - No E&P: Distribution Tax Free to Basis

§741 SALE PARTNERSHIP INTEREST

FMV \$300

Basis \$100

Gain \$200

- Liabilities Special Rules
- Subject to **§751**

REDEMPTION/LIQUIDATION

- If Received \$300 = Gain \$200
- If Receive assets \$300 Basis \$100
- §732 neither P'ship nor Partner
 - Recognizes any gain
- Basis in assets received \$100
- Gain & Income recognition deferred

CAPITAL ACCOUNTS

- First increased for revaluation gain
 - Inherent in distributed assets \$200
- Then – reduce capital account
 - of P'tr who received distribution
 - \$300 Capital Account Reduction

DID CAPITAL ACCOUNTS GO NEGATIVE?

- Depends on how gain allocated
- Added to Capital account balance
- Tracing allocation PIP?

PARTNERSHIP PURCHASE

- §741 – Capital Gain or Loss
- Subject to §751
- Ordinary Income
- Unrealized Accounts Receivable and Inventory
- Basis – Moving Target §705

Partnership Distributions

- §731(a). General Rule.- Partner
 - Gain on Distribution Not Recognized.
 - **Except**, if $\$ >$ Partner's Outside Basis
- §731(b). Partnership
 - No Gain/Loss recognized
 - On distribution to a Partner

Partnership Liquidating Distributions

- §732(a). General Rule.
 - **BASIS** of Property Distributed (Not \$)
 - Distributed by Partnership to Partner
 - Other than Liquidation of Partner's Interest
 - Partnership's Adjusted Basis of the Property
 - Immediately before distribution
 - **NOT > PARTNER'S OUTSIDE BASIS**

Partnership Liquidating Distributions

- §732(b) Basis of Property Distributed
 - Other Than Money
 - In Liquidation of Partner's Interest
 - Equal to Partner's Outside Basis
 - Less \$ Distributed

LIQUIDATION OF PARTNERSHIP INTEREST

- Redemption – termination of partner's entire interest by distributions
- Not by sale or exchange
- **Terminology is important**
- In professional practices often preferred
- §736(a) allows ordinary deduction if capital not material income producing factor

IRC § 736

- §736 classifies payments into two broad categories
- When a partnership makes liquidating distributions to retire a withdrawing partner's entire interest, the payments must be **ALLOCATED** between payment for the value of **partnership assets** and other payments for **unrealized receivables** and **unstated goodwill**

IRC §736(b)

- Payments for a partner's interest in **partnership property** (not unrealized receivables and unstated goodwill)
- Generally treated as distributions
- Taxed under rules applicable to nonliquidating distributions under IRC § 731
- Fair market values by arms-length agreement
- If related – use appraisal

§736(b) PAYMENTS

- §731 distribution rules govern
- Gain if: $\$ > \text{o/s Basis}$
- Includes sale or exchange treatment
– ordinary income (§751) can result
- Gain Deferred until basis recovered

TAX CONSEQUENCES OF §736(b)

- Gain recognized if retiring partner receives cash in excess of outside basis
- Basis property distributed equals outside basis reduced by cash distributed
- Basis first allocated to unrealized receivables or inventory, then to other distributed property in proportion to basis
- May recognize loss on a liquidating distribution if only cash, unrealized receivables, and §751(d)(2) inventory distributed

IRC §736(a)

- Payments not within §736(b)
- **Unrealized receivables** and **“unstated goodwill”** for a general partnership interest in a services partnership, and
- **“Premium”** payments

§ 736(a) PAYMENTS

- **DISTRIBUTIVE SHARE** – § 736 (a)(1), If determined with regard to partnership income
- **GUARANTEED PAYMENTS** – § 736(a)(2) treated as ordinary income. This applies to fixed payments.
- **EXCEPT** – As provided in § 736 (b).
- Should be clearly stated in partnership agreement

GOODWILL

- Stated or Unstated
- If Partnership Agreement **silent** with respect to goodwill; payments will be classified under §736(a).
- If stated goodwill §736(b)
- Therefore, parties have ability to construct tax treatment

IF §754 ELECTION IN EFFECT

If §754 election in effect, partnership may adjust the inside basis of its retained assets to prevent certain distortions

EXAMPLE 1 J RETIREMENT

	<u>FMV</u>	<u>J's 25%</u>
Cash	16,000	4,000
Unrealized A/R	260,000	65,000
Goodwill	<u>500,000</u>	<u>125,000</u>
Total	776,000	194,000

J RETIRED \$200,000

- Paid From Partnership
- P'ship Agreement **Silent** re: GW
- §736(a): $65k + 125k + 6k = \$196k$
- **P'ship Receives Deduction**
- §736(b) \$4,000 Cash
- §751 will apply

J AGREEMENT SALE/STATED GW

- J Ordinary Income §751 \$65k
- J Capital Gain Increased \$135k
 - Less Basis
- Partnership deduction \$65k
- Consider §754 Election
 - §197 Goodwill Write-off 15 years

EXAMPLE 2

- Jack: twenty-five percent (25%) general partner in service partnership where capital is not material income producing
- Partnership agreement is **SILENT** as to goodwill
- Jack's interest redeemed for \$6,000
- Assume \$2,000 outside basis

EXAMPLE 2 CONT.

	Fair Value Arms-Length	Jack's 25%
CASH	\$16,000.00	\$4,000.00
Unrealized Receivables	\$1,200.00	\$300.00
Goodwill	\$2,800.00	\$700.00
TOTAL	\$20,000.00	\$5,000.00

EXAMPLE 2 Cont.

- \$6,000.00 retirement of Jack's interest.
- Jack's share Partnership assets \$5,000
- Jack reports §736(a) payments of \$2,000 (\$300 + \$700 + \$1,000)
- Jack reports §736(b) payments of \$4,000. Jack's outside basis is (\$2,000). Capital Gain.
- The partnership receives a deduction of \$2,000.00

EXAMPLE 3

- The Partnership Agreement **REQUIRES** payment for goodwill.
- Goodwill treated as a §736(b)(1) payment; Partnership does not get a deduction; Jack reports **capital gain** not ordinary income
- **§754 Election**, the partnership may step-up the inside basis of the Goodwill and write-off over fifteen (15) years

COMPARISON CHART

	<u>CAPITAL</u>	<u>ORDINARY</u>
<u>REDEMPTION:</u>		
Unstated Goodwill	\$2,000	\$2,000
Stated Goodwill	\$2,700	\$1,300
SALE:	\$3,700	\$300

DISPUTES

Tolmach TCM 1991-538

- Partnership law firm
- Partnership claims “redemption”
- Agreement with partnership therefore liquidation/ redemption
- “Strong proof” needed to recast form (*Danielson*)

FOXMAN 352 F.2d 466 (3rd Cir. 1965)

- Accounting firm
- Agreement said “**SALE**” to partners
- Form & substance a sale
- §741 & §751

SELF EMPLOYMENT TAX

- §736(a) payments are generally subject to S/E tax
- PLR 200403056 discusses a way to avoid S/E tax

YOU MUST PLAN

- Under §1402(a)(10) and §1402(a)-17 A plan must be written and contain bona fide periodic retirement payments which will continue at least until the partners' death. Bona fide retirement payments may be based on various factors, such as, years of service and compensation in addition to age.
- In general, the retired partner cannot render services during the retirement period.
- Capital account must be paid in full before the end of the partnership year.

Clark Raymond & Co. PLLC v. Comm'r, T.C. Memo 2022-105 (10/13/22).

- Raises Additional Issues
- Two Partners Leave – Take Clients
- Partnership Agreement → Capital Account Provisions
 - Maintenance and Liquidation Agreement
 - Qualified Income Offset (QIO)

Capital Account Rules

- Increase Capital Account, as if Sale
- Then Decreased by Distribution
→ Of Clients to Partners
- Created Negative Capital Account!
- Income Allocated to Partners
→ Despite Fact that No \$ was Received
→ Partners “Agreed” to Have QIO

Was the Tax Court Correct?

- Did they compute capital accounts correctly?
- Purchase rules Respected?
- Major Partner Not Scrutinized.
- Did they Book-up properly?
- Partnership Agreement Clear?

RECOMMENDATIONS

1. Is QIO needed?
2. Include the following in agreements:
“Capital Accounts will be increased by FMV of Client based intangibles contributed.”
3. Consider Valuation Formula
→ Arms Length Agreements Respected
4. Include Overall “Book-Up” provisions

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Focus areas

- [Taxation](#)
- [Estate Planning](#)
- [Estate Administration](#)
- [Corporate and Commercial Transactions](#)

Biography

Robert S. Barnett, JD, Masters (Taxation), CPA, is a founding partner of Capell Barnett Matalon & Schoenfeld LLP, Attorneys at Law. His practice is highly concentrated in the areas of taxation, trusts, estates, corporate and partnership law and charitable planning. His experience includes Surrogate's Court practice, tax dispute resolution, Tax Court representation, and structuring financial transactions and charitable gifts.

Mr. Barnett applies creative and practical solutions to estate and business planning. He has served on many committees, is a frequent lecturer, and has published articles on numerous aspects of tax and business law. He is an active participant and serves on many professional and charitable boards.

Mr. Barnett received his juris doctor in 1986 from Fordham University, where he graduated cum laude and was a member of the Fordham Law Review. He graduated magna cum laude from Hofstra University, where he received his Bachelor's degree in accounting and is presently an adjunct professor in their graduate tax program. Mr. Barnett holds a Master's degree in taxation as the recipient of the highest dean's award. Mr. Barnett is admitted to practice law in New York, Virginia and Washington, D.C.