Sale or Redemption of a Partnership Interest – Is There a Difference?

Jul 27, 2023

Categories:

Blogs
Tax Law Defined™ Blog

Authors:

Martin E. Mooney

Partners in a partnership and members of a limited liability company that is taxed as a partnership (both referred to as a "Partnership") often face the issue of handling the retirement or other departure of an equity owner (referred to as a "Partner"). A question to address is whether it is better for the Partnership to redeem the outgoing Partner's interest or for each of the Partners to purchase a proportionate share of the equity interest of the outgoing Partner. From an economic perspective, in general, the remaining Partners will be in the same position regardless of whether they each purchase their respective proportionate interests from the outgoing partner or the partnership redeems the interest.

For example, assume a Partnership has four equal Partners, and one is retiring. From an economic perspective, the three remaining Partners will each end up with a one-third interest in the Partnership regardless of whether the Partnership redeems the interest of the outgoing Partner, or each Partner purchases one third of the equity interest of the outgoing Partner (possibly using funds provided by the Partnership). The issue to consider is whether there are any differences between the tax consequences of a redemption of the interest or a sale of the interest. As the examples below illustrate, there can be significant differences.

Example 1 – Retiring Partner in a Service Business

Assume our retiring partner is an attorney in an equally owned four-person legal practice that operates as a limited liability partnership (LLP). The LLP has negligible liabilities and typically pays out all profits to its Partners, so the basis of the outgoing Partner in the LLP is nominal and will be treated as zero for ease of illustration. The LLP operates on a cash basis. When the Partner retires, the LLP has two assets: unrealized receivables of $600,000 and goodwill of $2,000,000. The outgoing Partner will receive $650,000 either from the LLP as a redemption distribution or as a payment of $216,666.67

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

FBT Gibbons

from each of the other three Partners. What are the tax implications?

The tax consequences of the sale are straightforward. Pursuant to Section 741,[1] gain or loss from the sale of a partnership interest is treated as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751. In general, Section 751 requires the portion of the amount realized from the sale of a partnership interest attributable to unrealized receivables and inventory items of the partnership to be treated as ordinary income. In our example, the outgoing Partner will realize and recognize a gain of $650,000, with $150,000 of the gain attributable to the outgoing Partner's share of unrealized receivables and taxed as ordinary income, and $500,000 attributable to goodwill and taxed as long-term capital gain. If the LLP makes a Section 754 election on its return for the year of the sale, or has made one previously, then the remaining Partners will each get a basis increase under Section 743 of $50,000 for the unrealized receivables, which can offset receivables income as it is collected, and $166,666.67 for goodwill, which can be amortized over 15 years.

The tax consequences of the redemption payment depend on how the Partners agree to treat the payments. The portion of the redemption payment of $650,000 attributable to unrealized receivables will be ordinary income to the outgoing Partner, just as it would be in a sale. For the remaining Partners, Sections 736(a)(2) [2] and Sections 736(b)(2) and (3)[3] permit the LLP to deduct the portion of the payment attributable to unrealized receivables. In the sale alternative, the Section 743 adjustment to the outgoing Partner's share of unrealized receivables means no income is realized by the other Partners on the collection of that portion of the receivables. Although there is no basis adjustment to the outgoing Partner's share of unrealized receivables in a redemption, the ability to deduct the portion of the payment attributable to the outgoing Partner's share of unrealized receivables gives a timing advantage to the continuing Partners because the LLP will likely be able to deduct the Section 736(a) payments before the corresponding income is collected.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

Because capital is not a material income-producing factor for the LLP, and the retiring Partner was a general partner, Section 736 would also permit the LLP to deduct the portion of the payment to the outgoing Partner attributable to goodwill, but the outgoing Partner must treat the payment as ordinary income and self-employment income. Such treatment is permitted as long as the LLP's agreement does not provide for a payment with respect to goodwill, which is in the complete control of the Partners. If the LLP's agreement permitted a payment for goodwill, the outgoing Partner would recognize long-term capital gain on the portion of the redemption payment attributable to goodwill, and the LLP would get to adjust its basis in goodwill by $500,000 and amortize the goodwill over fifteen years pursuant to the rules of Section 734, provided the LLP makes a Section 754 election on its return for the year of the sale, or has made one previously.

Example 2: Partnership with Real Estate

Assume we again have a Partnership with four equal Partners who each have held their respective equity interests for several years. In our simple case, the Partnership has no liabilities, and its sole assets consists of real estate that was acquired by the Partnership for $10,000,000 with capital contributions made equally by the Partners. At the time of purchase, the land was valued at $1,000,000, and the depreciable portion of the real estate was valued at $9,000,000. The real estate has been fully depreciated by the Partnership and it has appreciated in value to $20,000,000. Each Partner has a remaining basis in the Partner's equity interest of $250,000. One of the Partners is about to retire and will receive a total payment of $5,000,000. How would a sale to each of the other three Partners of one-third of his equity interest for $1,666,666,67 differ from a redemption of the equity interest by the Partnership for $5,000,000?

Like Example 1, the tax consequences of a sale are straightforward. The outgoing Partner would recognize total gain of $4,750,000 ($5,000,000 total sale price less basis of $250,000), with $2,250,000 of the gain taxed at the rate of 25% applicable to unrecaptured Section 1250 gain and $2,500,000 taxed at the 20%

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

rate applicable to long-term capital gain. If the Partnership makes a Section 754 election on its return for the year of the sale, or has made one previously, then the remaining Partners would each get a basis increase under Section 743 of $1,583333.33 allocated between land and building based on the fair market value of each. The increase in the basis of the depreciable real estate would be recovered by each Partner over the appropriate recovery period.

Also, like Example 1, things are more complicated if the transaction is structured as a redemption. A redemption would trigger total gain to the outgoing partner of $4,750,000, just like a sale, but it appears that all of the gain would be taxed as long-term capital gain at a 20% rate and none as unrecaptured 1250 gain taxable at a 25% rate thereby providing a tax saving of $112,500 to the outgoing partner (5% x $2,250,000) compared with a sale. The Treasury Regulations under Section 1(h) provide that the rules that permit a portion of the gain from the sale of a partnership interest to be taxed at a 25% rate applies only to a ***sale*** of a partnership interest, but not to "a transaction that is treated, for Federal income tax purposes, as a redemption of a partnership interest."[4] As a result, the redemption allows the outgoing partner to escape the 25% rate applied to unrecaptured 1250 gain, which is a great result for the outgoing partner. The problem, however, is that there is uncertainty regarding the impact on the remaining Partners regarding their liability for the unrecaptured section 1250 gain the outgoing Partner has escaped. It is a distinct possibility the remaining Partners may be liable for the unrecaptured Section 1250 gain of the outgoing Partner. At a minimum, the remaining Partners would want to factor that potential liability into the redemption price paid to the outgoing Partner.

Example 3 – Timing of Gain Recognition in a Deferred Payment Transaction

Assume we again have a four-person Partnership with each Partner owning a 25% interest in the Partnership. Assume further that the balance sheet has no liabilities, and it has three assets: (i) unrealized receivables with a basis of zero and a current fair market value of $4,000,000; (ii) fully depreciated machinery and equipment that

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

was originally acquired for $5,000,000, with a current value of $2,000,000; and goodwill with a basis of zero and a current fair market value of $6,000,000. One of the Partners desires to retire. The Partners agree that he can retire and receive $3,000,000 for his equity interest in a lump sum payment on the third anniversary date of the sale. What would the tax differences between a redemption payment of $3,000,000 from the Partnership in three years and a payment of $1,000,000 from each of the other three Partners in three years?

If the transaction were structured as a purchase by the other three Partners, it would qualify as an installment sale under Section 453. In general, that would mean the retiring Partner could delay reporting recognition of income until the payments for the equity interest are received. There are, however, important exceptions to that general rule. Section 453(i) requires "recapture income" to be recognized in the year of sale.[5] Consequently, proceeds that would be treated as being attributable to depreciation recapture items under Section 751(a) must be reported as income in the year of sale by Section 453(i). Also, receivables cannot be reported under the installment sale rules. There had been limited authority regarding whether installment reporting was available for the portion of the sale price of a Partnership equity interest attributable to underlying cash-basis accounts receivable. In a Tax Court decision that was affirmed on appeal by the Fifth Circuit, the court held installment reporting was not available to the deferred portion of the sale price of a partnership interest attributable to the cash-basis accounts receivable of a personal service partnership.[6] It is not completely clear whether cash-basis receivables for the sale of goods would be treated the same way. At a minimum, there would be risk that installment sale treatment would not apply to the deferred portion of the sale price attributable to those receivables. In our case, the retiring Partner could be taxable in the year of sale on as much as $1,500,000 of the gain, all of which would be ordinary income. More importantly, the retiring Partner would not receive any cash for three years and would have to come up with funds to pay tax on the income recognized in the year of sale.

Another consideration for a transaction structured as a sale is that interest will be imputed to the amount paid under the rules of

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

Sections 1274 and 1274A, thereby converting a portion of the price paid from purchase price to interest, which would be ordinary income to the retiring Partner and deductible by the purchasing Partners. Because the purchase price paid by each of the other Partners would be less than $2,000,000, the purchaser and seller could elect to report interest on the cash method instead of using the original issue discount rules.[7] The purchasers would get an immediate step up in the receivables, the equipment, and the goodwill if the Partnership makes a Section 754 election in the year of sale, or has previously made the election.

In contrast, if the transaction were structured as a redemption, the installment sale rules would not apply. Instead, under Section 731, the retiring Partner would recognize income in the year the Partner receives payment. Under the rules of Section 751(b), $1,000,000 of the purchase price attributable to the receivables, and $500,000 attributable to depreciation recapture would be taxed as ordinary income. The $1,500,000 balance of the gain attributable to goodwill would be long-term capital gain. The key point is that no income would be reported until the retiring Partner receives cash for the redeemed equity interest, which means the Partner will have cash in hand from the transaction to pay the tax. Also, the imputed interest rules would not apply to the retiring Partner if the retiring Partner's equity interest is being redeemed by the Partnership rather than sold to the other Partners.

The remaining Partners would have to wait until year three when payment is made and the outgoing Partner recognizes income until basis adjustments are made to the receivables and the depreciable equipment under Section 751(b) and the goodwill under Section 734, if the Partnership makes a Section 754 election in the year of sale, or has previously made the election.

Example 4 – Holding Period Considerations

Assume the same facts as in Example 3 except that early in the year all four Partners each contribute $1,000,000 to the Partnership. Prior to the end of the year, the Partner retires. Instead of receiving a $3,000,000 for his equity interest, the Partner will receive a payment of $4,000,000. The $1,000,000 contribution would cause

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

the retiring Partner's basis in his equity interest to increase to $1,000,000, so the total gain recognized by the Partner remains at $3,000,000. Besides the differences between a purchase and a redemption described in Example 3, would the facts of Example 4 create any other differences?

In a purchase transaction, the retiring Partner would have to deal with the holding period rules for equity interests. Specifically, Section 1.1223-3(b)(1) of the Treasury Regulations provides, "*The portion of a partnership interest to which a holding period relates shall be determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).*" Applying our facts, 75% of the equity interest would have a long-term holding period ($3 million/$4 million), but the remaining 25% of the interest attributable to the $1,000,000 capital contribution made earlier in the year of sale would have a short-term holding period. As a result, for the $1,500,000 portion of the gain treated as capital gain (reduced by any imputed interest), 75% would be long-term capital gain taxed at a 20% rate and 25% of the gain would be short-term capital gain taxed at a 37% rate.

Section 1.1223-3(b)(1) of the Treasury Regulations sets forth a special rule to avoid the surprising and seemingly unfair result described in the preceding paragraph.[8] If the Partnership makes a distribution to a Partner in the same year a cash contribution is made, the Partner can reduce the amount of the cash capital contributions by the amount of distributions in applying the holding period rule. On our facts, the holding period problem could be eliminated entirely if the retiring Partner received a cash distribution of $1,000,000 from the Partnership in the year of sale, which would reduce the price paid for the retiring Partner's interest from $4,000,000 to $3,000,000, and the retiring Partner's basis in the equity interest from $1,000,000 to zero. On those facts, all of the capital gain recognized by the retiring Partner would be long-term capital gain.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

If the transaction were structured as a redemption, the holding period issue would not be a problem. The taxable event to the retiring Partner would occur in year three when the retiring Partner receives payment, the portion of the payment not attributable to Section 751 assets would be taxed as gain from the sale of the retiring Partner's equity interest. By then, all of the retiring Partner's equity interest would have a long-term holding period, so all of the capital gain recognized by the retiring partner would be long-term capital gain.

Conclusion

As the examples above illustrate, the tax consequences can be dramatically different depending on whether the buy-out of a retiring Partner's interest is structured as a cross-purchase or redemption. The parties need to understand these differences in order to achieve the desired after-tax outcomes and avoid unwanted surprises. For more information, contact the author of this article. You can also visit our Tax Law Defined® Blog for more insight into the latest developments in federal, state and local tax planning and tax administration.

---

[1] References to "sections" are to section of the Internal Revenue Code of 1986, as amended. This article addresses federal income tax consequences and does not address state and local tax consequences.

[2] Section 736(a)(2) of the Code states:

"Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

> (2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership."

[3] Sections 736(b)(2) and (3) of the Code state:

"(2) Special rules. For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for—

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

(A) unrealized receivables of the partnership (as defined in section 751(c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

(3) Limitation on application of paragraph (2).

Paragraph (2) shall apply only if—

(A) capital is not a material income-producing factor for the partnership, and

(B) the retiring or deceased partner was a general partner in the partnership.

[4] See Treas, Reg. §1.1(h)-1(b)(3)(ii).

[5] Section 453(i) of the Code states:

(i) Recognition of recapture income in year of disposition.

(1) In general. In the case of any installment sale of property to which subsection (a) applies—

(A) notwithstanding subsection (a) , any recapture income shall be recognized in the year of the disposition, and

(B) any gain in excess of the recapture income shall be taken into account under the installment method.

(2) Recapture income. For purposes of paragraph (1) , the term "recapture income" means, with respect to any installment sale, the aggregate amount which would be treated as ordinary income under section 1245 or 1250 (or so much of section 751 as relates to section 1245 or 1250) for the taxable year of the disposition if all payments to be received were received in the taxable year of disposition.

[6] Lori M. Mingo TC Memo 2013-149 (2013), aff'd 114 AFTR 2d 2014-6886 (2014, CA5).

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

[7] See Section 1274A(c) of the Code.

[8] Treas. Reg. Section 1,1223-3(b)(2) states,

(2) Special rule. For purposes of applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged (or with respect to which gain or loss is recognized upon a distribution under section 731), if a partner makes one or more contributions of cash to the partnership and receives one or more distributions of cash from the partnership during the one-year period ending on the date of the sale or exchange (or distribution with respect to which gain or loss is recognized under section 731), the partner may reduce the cash contributions made during the year by cash distributions received on a last-in-first-out basis, treating all cash distributions as if they were received immediately before the sale or exchange (or at the time of the distribution with respect to which gain or loss is recognized under section 731).

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.