

Part I

Section 721.--Nonrecognition of Gain or Loss on Contribution

26 CFR § 1.721-1: Nonrecognition of gain or loss on contribution.
(Also §§ 722, 723, 1001, 1012, 1223, 7701; 1.1223-1, 301.7701-3.)

Rev. Rul. 99-5

ISSUE

What are the federal income tax consequences when a single member domestic limited liability company (LLC) that is disregarded for federal tax purposes as an entity separate from its owner under § 301.7701-3 of the Procedure and Administration Regulations becomes an entity with more than one owner that is classified as a partnership for federal tax purposes?

FACTS

In each of the following two situations, an LLC is formed and operates in a state which permits an LLC to have a single owner. Each LLC has a single owner, A, and is disregarded as an entity separate from its owner for federal tax purposes under § 301.7701-3. In both situations, the LLC would not be treated as an investment company (within the meaning of § 351) if it were incorporated. All of the assets held by each LLC are capital assets or property described in § 1231. For the sake of simplicity, it is assumed that neither LLC is liable for any indebtedness, nor are the assets of the LLCs subject to any indebtedness.

Situation 1. B, who is not related to A, purchases 50% of A's ownership interest in the LLC for \$5,000. A does not contribute any portion of the \$5,000 to the LLC. A and B continue to operate the business of the LLC as co-owners of the LLC.

Situation 2. B, who is not related to A, contributes \$10,000 to the LLC in exchange for a 50% ownership interest in the LLC. The LLC uses all of the contributed cash in its business. A and B continue to operate the business of the LLC as co-owners of the LLC.

After the sale, in both situations, no entity classification election is made under § 301.7701-3(c) to treat the LLC as an association for federal tax purposes.

LAW AND ANALYSIS

Section 721(a) generally provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of the money and the adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

Section 723 provides that the basis of property contributed to a partnership by a partner shall be the adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at such time.

Section 1001(a) provides that the gain or loss from the sale or other disposition of property shall be the difference between the amount realized therefrom and the adjusted basis provided in § 1011.

Section 1223(1) provides that, in determining the holding period of a taxpayer who receives property in an exchange, there shall be included the period for which the taxpayer held the property exchanged if the property has the same basis in whole or in part in the taxpayer's hands as the property exchanged, and the property exchanged at the time of the exchange was a capital asset or property described in § 1231.

Section 1223(2) provides that, regardless of how a property is acquired, in determining the holding period of a taxpayer who holds the property, there shall be included the period for which such property was held by any other person if the property has the same basis in whole or in part in the taxpayer's hands as it would have in the hands of such other person.

HOLDING(S)

Situation 1. In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

Under § 1001, A recognizes gain or loss from the deemed sale of the 50% interest in each asset of the LLC to B.

Under § 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.

Under § 722, B's basis in the partnership interest is equal to \$5,000, the amount paid by B to A for the assets which B is deemed to contribute to the newly-created partnership. A's basis in the partnership interest is equal to A's basis in A's 50% share of the assets of the LLC.

Under § 723, the basis of the property treated as contributed to the partnership by A and B is the adjusted basis of that property in A's and B's hands immediately after the deemed sale.

Under § 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital assets and property described in § 1231 held by the LLC when it converted from an entity that was disregarded as an entity separate from A to a partnership. B's holding period for the partnership interest begins on the day following the date of B's purchase of the LLC interest from A. See Rev. Rul. 66-7, 1966-1 C.B. 188, which provides that the holding period of a purchased asset is computed by excluding the date on which the asset is acquired. Under § 1223(2), the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

Situation 2. In this situation, the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership when a new member,

B, contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.

Under § 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.

Under § 722, B's basis in the partnership interest is equal to \$10,000, the amount of cash contributed to the partnership. A's basis in the partnership interest is equal to A's basis in the assets of the LLC which A was treated as contributing to the newly-created partnership.

Under § 723, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is \$10,000, the amount of cash contributed to the partnership.

Under § 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital and § 1231 assets deemed contributed when the disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under § 1223(2), the partnership's holding period for the assets transferred to it includes A's holding period.

DRAFTING INFORMATION

The principal author of this revenue ruling is Matthew Lay of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling contact Mr. Lay at 202-622-3050 (not a toll-free call).