



# Whose Money Is It? – Capital Shifts and Their Taxability

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# Overview

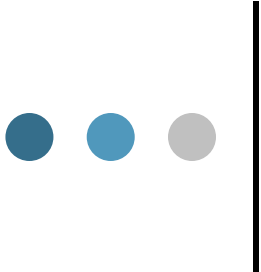
- What is a Capital Shift?
- Framework of Analysis
- Partnership options
- Forfeiture
- Preferred returns/guaranteed payments



# What is a Capital Shift?

## ➤ Base case:

- A and B each contribute \$100 to LLC
- A is preferred; B is common
- Liquidation rights
  - First \$100 to A
  - A and B share 30:70 thereafter
- Immediate liquidation: \$130 to A, \$70 to B



# Framework of Analysis

- Realization/Recognition principles
- Reason for shift: gift; compensation; “hard bargaining”?
- Relevant Authorities
  - Taxable shift: Lehman, 19 T.C. 659 (1953)
  - Non-taxable bargain purchase: Palmer, 302 U.S. 63 (1937)
  - Income definition/exceptions: §61(a); §1.721-1(b)(1)
  - Partnership option exercise tax-free: Prop. Reg. §1.721-2
  - Not a shift if from same partner? Lloyd, 15 B.T.A. 82 (1929)
  - Shifts before book up event: PLR 9821051



# Partnership Options

➤ Facts:

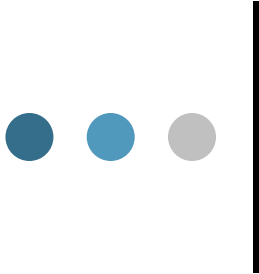
- 1/1/2010: value of LLC is \$90
- LLC grants C option for 10% interest for \$10 strike
- 1/1/2011: C exercises when LLC value is \$190
- Liquidation Amounts: C = \$20, A = \$90; B = \$90



# Forfeiture

➤ Facts:

- 1/1/2010: A, B, and C form LLC (value \$300)
- 1/1/2011: Capital call of \$100 from each member
- Alt 1: C doesn't pay and forfeits 50% to LLC
- Alt 2: A pays for C and 50% of C's interest shifts to A



# Preferred returns and guaranteed payments

➤ Facts:

- A and B each contribute \$100 to LLC
- Cash Waterfall
  - A = \$100 plus 10% annual preference
  - B = \$100
  - Remainder: 30% to A and 70% to B