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date: November 15, 2022

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(Small Business/Self-Employed)

from: Margaret Burow, Senior Counsel
(Passthroughs & Special Industries)

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subject: Character of gain on sales of limited liability company (LLC) interests

This Chief Counsel Advice responds to your request for assistance. This advice should not be used or cited as precedent.

LEGEND

Taxpayer =

X =

Y =

A =

B =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

State =

a =

b =

c =

d =

e =

f =

ISSUES

1. Whether § 1221 applies, despite § 741, to treat Taxpayer's gain on the sales of LLC interests as ordinary income because Taxpayer held the LLC interests primarily for sale to customers in the ordinary course of a trade or business during Year 3 through Year 4.

2. Whether §§ 741 and 751(d)(1) and (d)(3) apply collectively to treat Taxpayer's gain on the sales of LLC interests by Taxpayer as ordinary income because Taxpayer was engaged in a trade or business of selling land during Year 3 through Year 4.

CONCLUSIONS

1. Yes. Despite § 741, § 1221 applies to treat Taxpayer's gain on the sales of LLC interests as ordinary income because Taxpayer held the LLC interests primarily for sale to customers in the ordinary course of a trade or business during Year 3 through Year 4.

2. No. Sections 741 and 751(d)(1) and (d)(3) do not collectively apply to treat Taxpayer's gain on the sales of LLC interests as ordinary income because Taxpayer was not engaged in a trade or business of selling land during Year 3 through Year 4.

FACTS

Between Year 1 and Year 4, Taxpayer directly, and indirectly through entities owned and managed by Taxpayer (Managed LLCs),[1] engaged in the promotion and sale of interests in LLCs. The only asset held by the LLCs was land. Each of the LLCs engaged in transactions involving the donation of an easement with respect to the land,

[1] Taxpayer held, through disregarded entities, interests in the Managed LLCs with A and B through which Taxpayer engaged in the transactions described herein. Taxpayer reported the activities of the Managed LLCs as partnerships for federal tax purposes.

in exchange for a charitable contribution deduction, as described in Notice 2017-10,[2] and/or the donation of a fee simple interest in the land in exchange for a charitable contribution deduction. Hereinafter, because the analysis is the same and for ease of discussion, we refer to these transactions, collectively, as the SCE transactions and to the LLCs that donated the easements and/or land as the SCE LLCs. The character of the gain Taxpayer recognized on the sales of the SCE LLCs is the subject of this advice.

According to information provided by Taxpayer, Taxpayer has been engaged in a variety of business activities including real estate management, acquisition, and investment activities.[3] In at least Year 2, Taxpayer represented that Taxpayer and the Managed LLCs did not sell real property and were not engaged in a trade or business of selling real property.[4] Promotional materials for the sale of the SCE transactions described certain principals of Managed LLCs as "only providing additional information regarding the potential acquisition of membership interests to prospective members and are not acting as a real estate broker nor are they acting as a broker or dealer in securities."[5] During the audit of Taxpayer, LB&I Examination found that Taxpayer's activities are primarily operated through X, located in State, and that X conducts its activities through various Managed LLCs.

Transaction Steps[6]

Taxpayer, or Taxpayer through a Managed LLC, managed, marketed, and negotiated all transaction steps. From Year 1 through Year 4, Taxpayer generally undertook the following steps to promote and sell the SCE LLC interests. Taxpayer:

1. Identified a third-party owner of an undeveloped piece of land who held the land for more than one year (Landowner). Landowner formed an LLC (Land LLC) and contributed the undeveloped land to Land LLC.

2. Formed a Managed LLC that purchased a% of the interests in Land LLC from Landowner in exchange for cash.

3. Directed Land LLC to subdivide the undeveloped land into parcels, contribute one parcel each to several newly formed LLCs (SCE LLC),[7] and distribute the SCE LLC interests b% to Landowner and a% to Managed LLC, the same ownership percentages each held in Land LLC. Land LLC continued to hold one of the parcels.

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[2] 2017-4 I.R.B. 544.
[3] 30-day Letter Protest Taxpayer Resp. 2 for Year 2 Form 1040, p. 2.
[4] 30-day Letter Protest Taxpayer Resp. 2 for Year 2 Form 1040, p. 4.
[5] X, Year 3 Information Package for: Y, p. 4.
[6] In general, the transaction steps were the same when the SCE LLC donated easements and/or the land.
[7] Taxpayer reported the activities of the SCE LLCs as partnerships for federal tax purposes.

4. Directed Managed LLC to either continue to hold a% interest in each SCE LLC, or distribute the interest to its partners, Taxpayer, A, and B.

5. Managed LLC, or Taxpayer, A, and B, then sold c% of the SCE LLC interests to a newly formed LLC (Investor LLC) of which Managed LLC or Taxpayer was the managing member. Taxpayer used a different newly formed Managed LLC to sell the SCE LLC interests every year. Individual investors contributed tens of thousands of dollars into the Investor LLC to purchase the SCE LLC interests. Managed LLC, or Taxpayer, A, and B, continued to hold d% interest in and act as the managing member of SCE LLC.

Typically, within one to four months from the date of Land LLC's formation, the SCE LLC donated the easement and/or the land to a § 501(c)(3) organization.[8] The SCE LLC reported the donation as a charitable contribution on its federal tax returns. Taxpayer and the investors, through Investor LLC, claimed a deduction for their distributive shares of the charitable contribution deduction.

Taxpayer, through Investor LLC, made oral and written promises to the investors that they would receive a charitable contribution deduction with respect to the donation of the easement and/or the land many times the amount the investors contributed to Investor LLC.[9] Although the promotional materials for the Investor LLCs offered the investors several investment options, Taxpayer, acting as managing member of the SCE LLCs caused all the SCE LLCs to donate easements and/or the land to § 501(c)(3) organizations. Taxpayer, through Investor LLC, received a promotional fee or other consideration in connection with the sales of the SCE LLC interests to the investors.[10]

From Year 1 through Year 4, Taxpayer and the Managed LLCs, collectively, reported about $e of gain on the sales of their interests in f SCE LLCs to the Investor LLCs. Other than in Year 4, Taxpayer reported the gain from the sales of the SCE LLC interests as long-term capital gain.[11] In Year 4, Taxpayer sold SCE LLC interests directly and reported the gain from these sales as long-term capital gain. During Year 4, Taxpayer also formed an entity that elected to be treated as an S corporation for federal tax purposes. Taxpayer contributed SCE LLC interests to the S corporation that then sold the SCE LLC interests. Taxpayer reported gain on the sales of the SCE LLC interests sold by the S corporation as Schedule E ordinary income. On Taxpayer's personal tax return, Taxpayer reported no other source of income other than the income generated by Taxpayer from the promotion and sale of the SCE transactions.

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[8] X, Year 3 Information Package for: Y, pp. 7, 14, 21.
[9] X, Year 3 Information Package for: Y, pp. 14-15.
[10] X, Year 3 Information Package for: Y, p. 7.
[11] Each Managed LLC reported the sales of the SCE LLC interests as long-term capital gain, its share of the charitable deduction from the SCE LLC, and other expenses associated with the SCE transactions. Each Managed LLC also reported distributions of the SCE LLC sale proceeds.

LAW AND ANALYSIS

ISSUE 1

Ordinary income treatment under § 1221

Section 1221(a)(1) provides that "the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include" "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

In *Malat*, the Supreme Court stated, "[a]s used in § 1221(1), 'primarily' means 'of first importance' or 'principally.'"[12] The court also explained that the purpose of § 1221 "is to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand and 'the realization of appreciation in value accrued over a substantial period of time' on the other."[13]

The following factors indicate whether property is held primarily for sale to customers in the ordinary course of a trade or business: "(1) the frequency and regularity of sales; (2) the substantiality of sales;" (3) duration of ownership; (4) whether the property held for sale and property held for investment were separately identified; (5) purpose for acquiring the property; (6) sales and advertising efforts; (7) the time and effort devoted to the sales activity; and "(8) how the sales proceeds were used."[14] "The frequency and regularity of sales are among the most important factors in determining whether an asset is held for investment or as inventory."[15] Applying these factors, Taxpayer held directly, or through Managed LLCs, the SCE LLC interests primarily for sale to customers (investors).

(1) From Year 1 through Year 4, Taxpayer sold interests in f SCE LLCs to the Investor LLCs, the sales took place every year, and there were multiple investors in each Investor LLC.

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[12] *Malat v. Riddell,* 383 U.S. 569, 572 (1966).
[13] *Id.* (quoting *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 52 (1955); *Commissioner v. Gillette Motor Transport, Inc*., 364 U.S. 130, 134 (1960)).
[14] *Williford v. Commissioner*, T.C. Memo. 1992-450 (citing *United States v. Winthrop*, 417 F.2d 905, 910 (5th Cir.1969); *Byram v. United States*, 705 F.2d 1418, 1424 (5th Cir.1983); *Ross v. Commissioner*, 227 F.2d 265 (5th Cir.1955)).
[15] *David Taylor Enterprises, Inc. v. Commissioner*, T.C. Memo. 2005-127 (citing *Suburban Realty Co. v. United States*, 615 F.2d 171, 176 (5th Cir. 1980)).

(2) From Year 1 through Year 4, Taxpayer recognized gain of about $e from selling the SCE LLC interests to the Investor LLCs.

(3) The length of time from the acquisition of the Land LLC interests to the sale of Taxpayer's interests in the SCE LLCs was usually less than a year.

(4) Taxpayer did not separately identify property held for sale versus property held for investment with respect to the SCE LLC interests.

(5) Taxpayer directed Managed LLC to acquire an interest in the Land LLC from Landowners to create the SCE LLCs and sell interests in these SCE LLCs quickly, usually within a year.

(6) Each year from Year 1 through Year 4, Taxpayer vigorously advertised the SCE transactions, through promotional and other written materials and verbal communications, to attract investors who would contribute a minimum of tens of thousands of dollars to an Investor LLC. Taxpayer also engaged in significant sales activities, resulting in sales of interests in f SCE LLCs with multiple investors buying interests in Investor LLCs every year.

(7) Taxpayer devoted a substantial amount of time to the SCE transactions. Taxpayer found Landowner with whom Taxpayer negotiated a land purchase price, convinced the Landowner to structure the land sale as a sale of a% interest in Land LLC with Landowner keeping b% in Land LLC.[16] Taxpayer determined the scope and nature of the SCE transactions and arranged financing. Taxpayer directed the subdivision of land in Land LLC, the creation of SCE LLCs and placement of the subdivided land parcels into them, hired appraisers and other professionals, directed the creation of Investor LLC and the promotion and sale of interests therein to investors. As managing member of Investor LLC and in other ways, Taxpayer caused the SCE LLCs to donate the easement and/or the land. Taxpayer repeated these steps every year from Year 1 through Year 4.

(8) "Use of sales proceeds to replenish inventory indicates property is held for sale."[17] Taxpayer clearly intended to replace the SCE LLC interests being sold. From Year 1 through Year 4, Taxpayer created new SCE LLCs and sold Taxpayer's interests in them. The frequency and size of these transactions support that Taxpayer used the proceeds from the sales of the SCE LLC interests to purchase replacement properties for subsequent similar transactions.

In selling the SCE LLC interests, Taxpayer met each factor relevant to whether property is held primarily for sale to customers in the ordinary course of a trade or

[16] X, Year 3 Information Package for: Y, p. 2.
[17] *Williford*, T.C. Memo. 1992-450.

business. This confirms that, under § 1221(a)(1), Taxpayer held the SCE LLC interests as inventory "or property held… primarily for sale to customers in the ordinary course of Taxpayer's trade or business," not as capital assets. In addition, Taxpayer sold the SCE LLC interests quickly, generally within a year, and did not hold them on a long-term basis. Thus, under *Malat*, Taxpayer realized income "from the everyday operation of a business" and not "the realization of appreciation in value accrued over a substantial period of time." Therefore, Taxpayer's gain on the sales of the SCE LLC interests is ordinary income.

In *Corn Products Refining Co*., a corn products manufacturer's profits and losses from trading in corn futures were held to be ordinary income, not capital gains under the predecessor to § 1221.[18] The court determined that trading in corn futures was not "separate and apart from [the company's] manufacturing operations," but "a form of insurance against increases in the price of raw corn," which was "closely geared to [the] company's manufacturing enterprise [and very] important to its successful operation."[19]

The SCE LLC interests sold by Taxpayer are also excepted from the capital asset definition under *Corn Products*, as the SCE LLC interests are not "separate and apart from" Taxpayer's operations but are rather "closely geared to" Taxpayer's business, promoting SCE LLC interests, and are critically "important to its successful operation."[20]

Section 1221 applies despite § 741

Section 741 provides that in the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in § 751 (relating to unrealized receivables and inventory items).

While the general rule under § 741 treats the sale of partnership interests as a sale of a capital asset, here § 1221 applies, despite § 741, because the legislative history indicates that § 741 contemplates only the sale of partnership assets that are in fact capital assets.

The legislative history of § 741 shows that Congress intended to codify a line of court decisions that held that the sale of a partnership interest is generally considered to be a sale of a capital asset.[21] In enacting § 741, Congress stated that "[u]nder present decisions the sale of a partnership interest is *generally* considered to be a sale of a capital asset, and any gain or loss realized is treated as a capital gain or loss."[22] Further, Congress intended that "[t]he House and your committee's bill retain the

[18] *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955).
[19] *Id.* at 49-50.
[20] *Id*.
[21] *See Pollack v. Commissioner*, 69 T.C. 142, 148 (1977) (Tannenwald, J., dissenting).
[22] H. Rept. No. 1337, 83d Cong., 2d Sess. (1954) (emphasis added).

general rule of present law that the sale of an interest in a partnership is to be treated as the sale of a capital asset."[23]

In the cases prior to the enactment of § 741, the government took the position that the aggregate theory of partnership determined the result such that the sale of a partnership interest was a sale of the selling partner's undivided interest in each specific partnership asset.[24] The courts rejected the government's position and found that the sale of a partnership interest was the sale of a capital asset under § 117 (the predecessor to § 1221).[25] The courts that addressed the question of the treatment of the sale of partnership interests determined, in part, whether the entity or aggregate theory would prevail in the sale of a partnership interest.[26] In these cases, the courts reasoned that because partners did not have a separate or exclusive right to the partnership assets, but rather a common interest in all the assets, a partner's sale of their partnership interest should be treated as the sale of a capital asset as opposed to the sale of their interest in the partnership assets.[27]

Notably, the courts that addressed the treatment of the sale of a partnership interest in the pre-1954 cases did not deal with facts that showed the sale of a partnership interest was something other than the sale of a capital asset.[28] In other words, the courts were not given the opportunity to consider whether capital gain or ordinary income treatment would apply when a taxpayer was engaged in the business of holding partnership interests for sale to customers. Given the facts of the pre-1954 cases and Congress's intent to codify a line of cases that held that the entity approach should determine the consequences of the sale of a partnership interest, Congress intended to give capital asset treatment only to the sale of partnership interests that are in fact held as capital assets.

Further, Congress's statement that § 741 retained merely the general rule of present law that the sale of a partnership interest is treated as the sale of a capital asset leaves open the possibility for ordinary treatment on the sale of a partnership interest when the facts and circumstances are appropriate.

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[23] S. Rept. 1622, 83d Cong., 2d Sess. (1954) (emphasis added).
[24] GCM 26379, 1950-1 C.B. 58.
[25] *See, e.g.*, *Kessler v. United States* 124 F.2d 152, 153 (3rd Cir. 1941); *Commissioner v. Shapiro* 125 F.2d 532, 533 (6th Cir. 1942); *Long v. Commissioner*, 173 F.2d 471, 471-72 (5th Cir. 1949) (finding that a partner's sale of a partnership interest is a sale of a capital asset, rather than his share of each asset owned in the partnership).
[26] *See*, *e.g.*, *Kessler supra*; *Commissioner v. Lehman*, 165 F.2d 383, 384 (2nd Cir. 1948).
[27] *See, e.g.*, *Shapiro supra*; *Commissioner v. Smith*, 173 F.2d 470, 470 (5th Cir. 1949); *Thornley v. Commissioner*, 147 F.2d 416, 422; *Lehman*, 165 F.2d at 385-386.
[28] *See, e.g.*, *Kessler supra* (advertising agency partnership); *Shapiro*, *supra* (partnership engaged in the business of manufacturing and selling cosmetics and medicines); *Thornley*, 147 F.2d at 416-17 (3rd Cir. 1944) (advertising agency partnership); *Stilgenbaur v. United States*, 115 F.2d 283, 285 (9th Cir. 1940) (general produce partnership); *Lehman supra* (brokerage business partnership); *Smith supra* (oil-field retailer partnership); *Long supra* (drilling partnership).

Here, because the substance of the sales of the SCE LLC interests by the Taxpayer (and the Managed LLCs) were necessary steps in the SCE transactions (facilitated using LLC interests) in the ordinary course of Taxpayer's trade or business of selling SCE LLC interests, § 1221(a)(1) applies to determine the character of the gain on such sales. We are not challenging the entity approach of partnership taken by § 741 (i.e., that the sale of a partnership interest is treated as the sale of a single asset, like corporate stock). The application of § 1221 under the present set of facts harmonizes §§ 1221 and 741 such that capital gain treatment does not apply when a taxpayer's gain or loss arises from the everyday operation of a trade or business. Thus, § 741 does not foreclose treating the gain on the sale of the SCE LLC interests as ordinary income in situations when, as here, the SCE LLC interests were pre-arranged products frequently created and sold to customers (investors).

ISSUE 2

Sections 751(a)(2) and (d)(1)

Section 751 is the exception to the general rule under § 741, which provides capital gain treatment for the sale of a partnership interest. Section 751(a) provides that on the sale or exchange of an interest in a partnership, the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to (1) unrealized receivables of the partnership, or (2) inventory items of the partnership, shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

Section 751(d) provides that for purposes of this subchapter, the term inventory items means: (1) property of the partnership of the kind described in § 1221(a)(1); (2) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in § 1231; and (3) any other property held by the partnership which, if held by the selling partner, would be considered property of the type described in § 751(d)(1) and § 751(d)(2).

Section 751(a)(2) and (d)(1) collectively apply to characterize as ordinary income the gain recognized from the sale of a partnership interest attributable to partnership property of the kind described in § 1221(a)(1).[29] In other words, ordinary treatment would be appropriate when (i) a partnership asset is inventory to the partnership, or (ii) when a partnership asset is held by the partnership primarily for sale to customers in the ordinary course of the partnership's trade or business.

[29] Section 1221(a)(1) excludes from the definition of capital asset: stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Here, the facts presented do not support that the land was included in the inventory[30] of the SCE LLCs or held by the SCE LLCs primarily for sale to customers. Additionally, there are no facts to support that the SCE LLCs were engaged in the trade or business of selling land. Each SCE LLC donated the easement, and/or the land, to a § 501(c)(3) organization on behalf of the investors. Therefore, § 751(a)(2) and (d)(1) collectively would not apply to characterize the gain recognized by Taxpayer (or the Managed LLCs) as ordinary income.

Section 751(a)(2) and (d)(1) would apply, however, to characterize the gain recognized by Taxpayer (or the Managed LLCs) as ordinary income if additional facts are presented to support their application. That is, the facts must support that the SCE LLCs were engaged in the trade or business of selling land and that the land held by the SCE LLCs was either inventory or held primarily for sale to customers by the SCE LLCs.

Sections 751(a)(2) and (d)(3)

Collectively, § 751(a)(2) and (d)(3) apply to characterize as ordinary the gain recognized from the sale of a partnership interest attributable to partnership property, which, if held by the selling partner, would be considered: (1) property of the kind described in § 1221(a)(1) and (2) any other property considered to be other than a capital asset and other than property described in § 1231. In other words, ordinary treatment would be appropriate when a partnership asset, if held by the selling partner is, property other than a capital asset to the selling partner; inventory to the selling partner; or held by the selling partner primarily for sale to customers in the ordinary course of the selling partner's trade or business.

Here, the facts presented do not support that Taxpayer (or the Managed LLCs) was in the trade or business of selling land. Promotional materials for the SCE transactions described Taxpayer as not acting as a real estate broker with respect to the SCE transactions. Additionally, in at least one year Taxpayer stated that neither Taxpayer, nor the Managed LLCs, sold land and was not engaged in the business of selling land. Accordingly, the land in the SCE LLCs, if held by Taxpayer (or the Managed LLCs), would have been a capital asset to Taxpayer (or the Managed LLCs) because there is no indication that the land was inventory to the Taxpayer (or the Managed LLCs) or held by Taxpayer (or the Managed LLCs) primarily for sale to customers in the ordinary course of the Taxpayer's (or the Managed LLCs') trade or

[30] Here and elsewhere in this document, potential characterization of real property as inventory is included in the analysis for the sake of consistency with the statutory language in § 751. However, note that the Tax Court has held that real property does not constitute merchandise within the meaning of § 471. *See W.C. & A.N. Miller Development Company v. Commissioner*, 81 T.C. 619 (1983). Accordingly, ordinary income treatment would depend on a determination that the underlying real property constitutes property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

business. Therefore, § 751(a)(2) and (d)(3) collectively would not apply to characterize the gain recognized by Taxpayer (or the Managed LLCs) as ordinary income.

Section 751(a)(2) and (d)(3) would apply, however, to characterize the gain recognized by Taxpayer (or the Managed LLCs) on the sales of the SCE LLCs as ordinary income if additional facts are presented to support their application. That is, the facts must support that the Taxpayer (or the Managed LLCs) was engaged in the business of selling land. In addition, the facts must support that the land held by the SCE LLCs was (i) inventory to the Taxpayer (or the Managed LLCs); (ii) property other than a capital asset to the Taxpayer (or the Managed LLCs); or (iii) property held by the Taxpayer (or the Managed LLCs) primarily for sale to customers.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call Alta Li of the Office of Associate Chief Counsel (Passthroughs & Special Industries) at (202) 317-5279 if you have any further questions.