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Planning Required When Sale of Partnership Assets Includes Deferred Compensation

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When selling an operating business owned by a partnership (or a limited liability company taxed as a partnership), sellers need to analyze the tax impact of deferred compensation as part of its due diligence before closing. The timing of the payment of deferred compensation is key in determining its deductibility by the seller, as former NBA team owners learned in *Hoops v. Commissioner*, T.C. Memo 2022-9 (February 23, 2022). Ultimately, the tax court ruled that the timing of the payment of deferred compensation owed to two of its former players prevented it from deducting the payment.

Background

In 2012, Hoops, LLC, a Delaware limited liability company taxed as a partnership (Hoops), was the owner of the Memphis Grizzlies, an NBA basketball team. Hoops agreed to sell substantially all of its assets, which were the Grizzlies franchise and related assets, to Memphis Basketball, LLC (buyer). As part of that sale, the buyer was to assume substantially all of the liabilities of Hoops, including over $12 million of deferred compensation owed to two former players, Zach Randolph and Michael Conley.

On its 2012 federal tax return, Hoops included the discounted value of the liability for the deferred compensation (over $10 million) in the calculation of its gain on sale. Less than a month later, Hoops amended the return claiming a deduction for this deferred compensation based upon Treasury Regulation section 1.461-4(d)(5), which allows an accrual basis taxpayer to treat certain liabilities assumed in the connection with the sale of a trade or business as incurred if, "but for the economic performance requirement would have been entitled to incur as of the date of the sale…." The Internal Revenue Service then issued a final partnership administrative adjustment disallowing this deduction, which was ultimately challenged in the tax court.

Analysis

When selling the assets of a partnership, section 1001(b) of the Internal Revenue Code (the Code) includes the amount of liabilities from which the transferor is discharged in the definition of "amount realized". Meaning, these assumed liabilities are taxed as if these amounts were received by the partnership as part of the purchase price.

In analyzing the deductibility of the payments, the tax court noted that that section 404(a) of the Code governs the deductibility of deferred compensation payments. Looking to the plain language of section 404(a)(5) of the Code, the tax court focused on the limitation that the deferred compensation is not deductible until the year the payments are includible in gross income of the employees. Since the payments were not paid until after 2012, neither of the two former players were taxed on the income in 2012 and therefore the deferred compensation liability could not be deducted by Hoops in 2012.

Hoops argued that section 461(h) of the Code allows an accrual basis taxpayer to deduct expenses in the year those expenses were incurred regardless of when paid. Hoops further argued that Treasury Regulation section 1.461-4(d)(5) allowed it to accrue the deferred compensation payments in 2012. However, the court found this argument unconvincing. The court maintained its focus on section 404(a)(5), ruling that the limitations of section 404(a)(5) of the Code are expressly applicable to the timing of the deduction of deferred compensation, not the failure to satisfy an economic performance requirement.

As such, Hoops was required to recognize the assumed deferred

compensation as income, but was unable to take any deductions related to the payment.

Key Takeaways

The parties to the sale of a business often get bogged down in the tax implications of the sale, and often express a desire to structure the transaction in a tax-efficient manner. Recognizing the impact of deferred compensation payments can be a critical part of that analysis.

If permitted without penalty under section 409A of the Code and allowed under the deferred compensation plan, a seller may want to accelerate deferred compensation payments to make them deductible. If not, a buyer may want to consider retaining the liability to protect the related deduction.

Nevertheless, to put itself in the best negotiating and tax planning position, selling partnerships and limited liability companies need to analyze the tax impact of deferred compensation, particularly the timing of payments, as part of its due diligence before closing.■