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PARTNERSHIP DISGUISED SALE RULES

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Partnership Disguised Sale Rules

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I. Introduction

When a disguised sale issue arises, it usually arises in the context of a disguised sale of property; that is, generally, a contribution of property followed by a distribution of cash or other property back to the contributing partner.[1] If the contribution and distribution are treated as unrelated events, section 721(a)[2] ordinarily prevents the contributing partner and the partnership from recognizing gain or loss on the contribution, and section 731 ordinarily prevents the partner and the partnership from recognizing any gain or loss on the distribution. However, if the contribution and distribution are properly treated as two halves of a single transaction (to wit, the sale of property by the partner to the partnership), sections 721 and 731 will not apply. Instead, the transaction ordinarily will be treated as a taxable sale or exchange between the partner and the partnership under section 1001.

Less frequently, a disguised sale issue arises in the context of a disguised sale of a partnership interest. In this case, a partner contributes property or cash to a partnership, and the partnership (either before or after the contribution) distributes cash or property to another partner. Like in the disguised sale of property context, section 721(a) ordinarily prevents the contributing partner and the partnership from recognizing gain or loss on the contribution, and

[1] A disguised sale of property could occur as well by a partnership distributing property to a partner and the distributee partner contributing cash or other property to the partnership.

[2] Unless otherwise stated or clear from context, a reference to a "section" in this outline is to a section of the Internal Revenue Code of 1986 (the "Code"), as amended from time to time. A reference to "Treas. Reg. §" in this outline is to a section of the Treasury regulations issued under the Code.

section 731 ordinarily prevents the distributee partner and the partnership from recognizing any gain or loss on the distribution. However, if the contribution and distribution are properly treated as two halves of a single transaction, sections 721 and 731 may not apply. Instead, the transaction may be treated as a sale or exchange of a partnership interest from the distributee partner to the contributing partner.

Prior to 1984, it was unclear under the relevant case law whether a partner could engage in a disguised sale of property or in a disguised sale of a partnership interest (collectively, a "disguised sale"). By enacting section 707(a)(2)(B) in 1984, Congress unequivocally indicated that a partner could engage in a disguised sale. However, Congress expressed its will in section 707(a)(2)(B) via a call for Treasury regulations rather than placing the substantive rules directly into the Code. Thus, in the absence of Treasury regulations, it remained uncertain whether a partner could engage in a disguised sale. In 1992, the Treasury Department (the "Treasury") and the Internal Revenue Service (the "Service") issued final Treasury regulations regarding the disguised sale of property (the "property regulations"). Such regulations are widely regarded as providing a workable structure of rules without imposing an inappropriate administrative burden on taxpayers. However, such regulations expressly reserve on the issue of whether a partner can engage in a disguised sale of a partnership interest. In 2004, Treasury and the Service issued proposed Treasury regulations regarding the disguised sale of partnership interests (the "proposed interest regulations"). In 2009, Treasury and the Service withdrew the proposed interest regulations. Although many of the rules in the proposed interest regulations were similar to the rules in the property regulations, certain aspects of the proposed interest regulations would have increased significantly the complexity of section 707(a)(2)(B) and the administrative burden on taxpayers for all types of disguised sales. Currently, the determination of whether

transfers between a partner (or partners) and a partnership constitute a transfer of a partnership interest is based on the statutory language, guidance provided in legislative history, and case law.

The succeeding sections of this outline trace the gradual development of the rules regarding disguised sales. A detailed discussion is included regarding the disguised sale case law addressing taxable years prior to the enactment of section 707(a)(2)(B), the final property regulations, the administrative guidance other than Treasury regulations that addresses disguised sales of partnership interests, and the withdrawn proposed interest regulations.

II. Disguised Sale Rules Prior to Section 707(a)(2)(B)

A. Statutory Guidance Prior to Section 707(a)(2)(B) - Section 707(a)

Prior to the enactment of section 707(a)(2)(B), section 707(a) read (and continues to read): "If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner." This provision arguably provided (and still provides) the Service with statutory authority to challenge disguised sale of property transactions. However, the reference in the provision to recasting the transaction as occurring between the partnership and a third party does not appear to capture disguised sale of partnership interest transactions, since the appropriate recast of such a transaction generally is a sale or exchange between two partners without the involvement of the partnership.

B. Regulatory Guidance Prior to Section 707(a)(2)(B)

1. Treas. Reg. § 1.707-1(a):

Treas. Reg. § 1.707-1(a) has provided since 1956, "[T]ransfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions included within the provisions of [section 707(a)]. In all cases, the substance of the transaction will govern rather than its form. See paragraph (c)(3) of § 1.731-1." T.D. 6175 (May 23, 1956) (Emphasis added). Thus, this Treasury regulation provided (and still provides) that transactions that are otherwise described in section 721 or 731 will not be recast under section 707(a) unless the form of the transactions as section 721 contributions or section 731 distributions does not comport with its substance. Accordingly, this Treasury regulation appears to confirm that a putative contribution followed by or preceded by a putative distribution could be recast under section 707(a) as some other transaction (e.g., a disguised sale of property between a partner and a partnership).

2. Treas. Reg. § 1.721-1(a)

Treas. Reg. § 1.721-1(a) has provided since 1956, "Section 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See paragraph (c)(3) of § 1.731-1. Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration . . . , the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721." See T.D. 6175 (May 23, 1956) (Emphasis added). Like Treas. Reg. § 1.707-1(a), this Treasury regulation emphasizes that the substance over form

principle controls the tax treatment of any contribution ostensibly described in section 721(a). Furthermore, it confirms that, if a transfer of property by a partner to a partnership is not a contribution in substance, the transfer will be treated as a sale or exchange under section 707.

3. Treas. Reg. § 1.731-1(c)(3)

Treas. Reg. § 1.731-1(c)(3) has stated since 1956, "If there is a contribution of property to a partnership and within a short period: (i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or (ii) After such contribution the contributed property is distributed to another partner, such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property." See T.D. 6175 (May 23, 1956) (Emphasis added). Like Treas. Reg. § 1.707-1(a) and Treas. Reg. § 1.721-1(a), this Treasury regulation explicitly incorporates the substance over form principle into section 731. However, unlike the other Treasury regulations, this regulation expands the apparent scope of the potential recasts of a disguised sale. Treas. Reg. § 1.731-1(c)(3) explicitly provides that a putative contribution and putative distribution could be recast as either a disguised sale of property between a partner and a partnership or a disguised sale of property between two partners. At first blush, the Treasury regulation's reference to transactions between partners may not be viewed as referring to disguised sales of partnership interests (but rather a disguised sale of property between partners). However, in the case of a disguised sale of property between partners, the words of the Treasury regulation appear broad enough to include the receipt of

consideration by the contributing partner in the form of an interest in the partnership from the putative distributee partner (i.e., a disguised sale of a partnership interest). The ambiguity seems to rest in the Treasury regulation's focus on the treatment of the putative distribution of property without addressing the treatment of the putative contribution.

C. Relevant Case Law Regarding Taxable Years Prior to Section 707(a)(2)(B)

Despite this backdrop of statutory and regulatory guidance, there was considerable controversy prior to 1984 over whether a contribution to a partnership that was proximate to a distribution from a partnership should be considered a disguised sale of property between the contributing partner and the partnership. Even more controversy existed over whether a contribution to a partnership that was proximate to a distribution from a partnership should be considered a disguised sale of a partnership interest. These controversies, in part, stemmed from the fact that courts addressing disguised sale issues for taxable years prior to 1984 applied the statutory and regulatory guidance described above and still did not find a disguised sale in a majority of cases. However, courts did find a disguised sale in a few cases.

1. Case Law Not Finding a Disguised Sale

a. Harris v. Commissioner, 61 T.C. 770 (1974) (no disguised sale of partnership interest)

(i) Facts

In 1962, the taxpayer contributed a 40 percent undivided interest in real property to a partnership, and the partnership took such property subject to a pre-existing purchase money mortgage debt. The real property was the partnership's principal asset, and the use of such

property was the partnership's sole business. In a later year, the taxpayer decided that his investment in the real property (through the partnership) was becoming unprofitable, and, thus, the taxpayer formed the intent to dispose of his interest in the real property. The taxpayer unsuccessfully attempted to solicit purchase offers satisfactory to the other partners.

The taxpayer eventually divested himself of his interest in the real property in the following manner. In 1967, the partnership sold an undivided 10 percent interest in the real property (and transferred a 10 percent interest in the related debt) to several trusts, and the trusts leased the property back to the partnership for monthly rental payments that generally equaled 10 percent of the monthly mortgage payment on the entire debt. The trustees and beneficiaries of the trusts were not (and did not become) partners in the partnership. Prior to the transfer of the real property to the trusts, the partners agreed that the proceeds from the sale would be distributed solely to the taxpayer in exchange for a portion of his partnership interest. The sale proceeds were, in fact, distributed in accordance with the partners' agreement.

In 1968, the taxpayer withdrew from the partnership in exchange for a 30 percent undivided interest in the real property of the partnership subject to the existing debt. On the same day as the distribution, the taxpayer leased the property back to the partnership under terms similar to the terms of the leaseback in 1967. Roughly two months after the distribution and leaseback, the taxpayer sold the distributed 30 percent undivided interest in the real property to several trusts. The trustees and beneficiaries of the trusts were not (and did not become) partners in the partnership.

(ii) Relevant Arguments

The taxpayer took the position that the sales in 1967 and 1968 involved the sale of real property, which resulted in ordinary losses. The Commissioner of Internal Revenue (the "Commissioner") argued that, if the sales were assumed to be bona fide, the losses realized from the sales would be capital, since what was sold were the taxpayer's partnership interests rather than interests in real property.

(iii) Ruling

The Tax Court applied a facts and circumstances approach to determine the substance of the transactions. The court held that the sale in 1967 was not a disguised sale of a portion of the taxpayer's interest in the partnership, because (i) the form of the transaction was a sale of real property rather than a sale of a partnership interest, (ii) there was no intent by the parties for the purchasers to become partners of the partnership, (iii) the sale did not entitle the purchasers to an interest in any of the other assets of the partnership, (iv) the sale did not entitle the purchasers to any of the profits of the business of the partnership, and (v) the sale did not entitle the purchasers to any liquidation proceeds from the partnership. The court also held that the sale in 1968 was not a disguised sale of a portion of the taxpayer's interest in the partnership, because (i) the taxpayer did not own a partnership interest at the time that he sold his 30 percent undivided interest in the real property (i.e., the purchasers of the property could not have purchased a partnership interest from the taxpayer at the time they purchased the real property from him), (ii) the sale did not entitle the purchasers to any of the profits of the business of the partnership, and (iii) the sale did not entitle the purchasers to any liquidation proceeds from the partnership.

b. Otey v. Commissioner, 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (6th Cir. 1980) (no disguised sale of property)

(i) Facts

The taxpayer ("Taxpayer") formed a general partnership with another ("Thurman") in 1971 to develop a residential apartment project. Taxpayer contributed real property with a fair market value of $65,000 to the partnership. Thurman did not contribute property. However, Thurman's creditworthiness was necessary for the partnership to borrow the funds necessary to develop the apartment project on the contributed real property. Further, the partnership could not borrow the necessary funds unless it owned the real property upon which the apartments were to be built. In 1972, the partnership borrowed roughly $870,000 on a recourse basis for the apartment project and then, pursuant to the partnership agreement, distributed $65,000 of the loan proceeds to Taxpayer over the next five months. Taxpayer and Thurman shared equally in the profits and losses of the partnership, and distributions were to be made equally after the first $65,000 was paid to Taxpayer. The parties intended Taxpayer's contribution to be treated as a contribution to the capital of the partnership rather than a sale to the partnership.

(ii) Relevant Arguments

The Commissioner argued that Taxpayer's contribution transaction had been engaged in by him in other than in his capacity as a partner of the partnership, and, pursuant to section 707(a), Treas. Reg. § 1.707-1(a), and Treas. Reg. § 1.731-1(c)(3), the contribution transaction should be treated as a sale of the real property to the partnership for $65,000.

Taxpayer argued that the contribution of the real property and the subsequent distribution of loan proceeds fell under sections 721 and 731, respectively.

(iii) Ruling

The Tax Court explained that the Code (prior to the enactment of section 707(a)(2)(B) in 1984) provides two possible ways of analyzing the transfer -- either under sections 721 and 731 or under section 707. "Neither the Code and regulations nor the case law offers a great deal of guidance for distinguishing whether transactions such as those before us are to be characterized as a contribution (nontaxable) under section 721 . . . or as a sale to the partnership other than in the capacity of a partner (taxable) under section 707 . . . ."

The court then applied a facts and circumstances approach to determine the substance of the transactions. The court found (and the Sixth Circuit affirmed) that the transactions, in substance, did not constitute a disguised sale by Taxpayer of the real property to the partnership, because (i) the form of the transaction was a contribution to capital, (ii) the real property contributed was the only asset of the partnership (i.e., without the real property, the partnership would have had no assets and no business), (iii) there would have been no non-borrowed capital in the partnership without the contribution of the real property, and partnerships without any non-borrowed capital are unusual, (iv) there was no guarantee that Taxpayer would receive (and be able to keep) the $65,000 of proceeds at the time of the contribution of the property to the partnership since there was no guarantee that the partnership would receive the loan and Taxpayer was personally liable for the entire partnership borrowing (i.e., whether the partnership cash flow would ever suffice to repay the distributed money to the bank would depend on the partnership's subsequent economic fortunes), (v) it is commonplace to have an

arrangement in which a partner who invested a greater share of capital will receive preferential distributions to equalize capital accounts, and (vi) Taxpayer could have borrowed the funds on the security of his real property and applied them to his personal use without triggering gain if no partnership existed in the first place.

The court, however, warned that had the distributed funds come directly from the other partner, the Commissioner's case would have been stronger. With respect to this warning, the court stated: "While it may be argued that the funds have come indirectly from Thurman because his credit facilitated the loan, the fact is that the loan was a partnership loan on which the partnership was primarily liable, and both partners were jointly and severally liable for the full loan if the partnership defaulted."

c. Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980) (no disguised sale of partnership interest) [hereinafter CSC]

(i) Facts

A partnership was organized to extend access to the international communications satellite network as broadly as possible pursuant to a United Nations directive. After the initial formation of the partnership by certain partners (including the plaintiff), new partners could enter the partnership by making a capital contribution under a formula the purpose of which was to treat the new partners as if they were in the same position they would have been if they had been partners since the inception of the partnership. In accordance with the partnership agreement, the capital contributed to the partnership by the new partners was distributed pro rata to the existing partners to reduce the existing partners' percentage interests. This method was used due to

uncertainties in valuing the partnership's assets at any specific stage of development or operation. The effect of this method was to admit new partners without any negotiations with the partnership or the existing partners. In 1971 and 1972, six new partners were admitted to the partnership in exchange for capital contributions based on the formula in the partnership agreement. Immediately after the contributions in 1971 and 1972, the plaintiff received its pro rata share of the contributions as distributions from the partnership.

(ii) Relevant Arguments

The government argued that the contributions and distributions should be treated, pursuant to Treas. Reg. § 1.731-1(c)(3), as a taxable sale of a part of the plaintiff's partnership interest to the new partners. The plaintiff took the position that the contributions and distributions fell under sections 721 and 731, respectively.

(iii) Ruling

The Court of Claims cited Treas. Reg. § 1.707-1(a) in recognizing that, in applying Treas. Reg. § 1.731-1(c)(3), substance controls over form. "To determine the substance of the transactions, we consider all of their aspects that shed any light upon their true character." Thus, the court applied a facts and circumstances test to determine the substance of the transactions. The court found that the transactions did not amount to a disguised sale of a partnership interest from the plaintiff to the new partners, because (i) the partnership had a unique purpose which was not for economic advantage, and (ii) there were several characteristics of these transactions not commonly associated with sale transactions. These characteristics were as follows: (i) the existing and new partners did not negotiate sales of partnership interests, (ii)

the existing partners had no control over the admission of new partners, and (iii) the amount of each new partner's capital contribution was not tied to the fair market value of the partnership interest to be received in return.

d. Park Realty Company v. Commissioner, 77 T.C. 412 (1981) (no disguised sale of property)

(i) Facts

The taxpayer corporation commenced development of a shopping center on land that it owned and incurred development costs with respect to the land. Unable to raise adequate financing itself, the taxpayer formed a limited partnership with another developer in 1974. The taxpayer contributed to the partnership the land, which was worth $500,000, in exchange for a 25 percent limited partner interest, and the developer contributed $100 of cash in exchange for a 75 percent general partner interest. In 1975, the partnership sold portions of the land for cash to future tenants of the shopping center. Pursuant to the partnership agreement, such cash proceeds, which amounted to roughly $486,000 in aggregate, were then distributed later in 1975 to the taxpayer to reimburse the taxpayer for the pre-contribution development costs incurred with respect to the contributed land. The taxpayer reported the transactions on its Federal income tax returns as a contribution of land to the partnership in a transaction described in section 721(a) followed by a distribution of cash from the partnership in a transaction described in section 731.

(ii) Relevant Arguments

The Commissioner argued that, although the contribution of the land itself to the partnership was a transaction described in section 721(a), the contribution of the development costs and the distribution in reimbursement of such costs should be treated as a taxable sale of such costs from the taxpayer to the partnership under section 707(a). The Commissioner also requested that the Tax Court reconsider and overrule its earlier decision in Otey. The taxpayer argued that the transfer of the land to the partnership constituted a contribution of the land and the associated improvements attributable to the development costs to the partnership in a transaction described in section 721(a), and the transfer of cash from the partnership to the taxpayer constituted a distribution of cash from the partnership in a transaction described in section 731.

(iii) Ruling

For purposes of the opinion, the Tax Court assumed that the development costs constituted an asset, and that such asset was separable from the land. Even under this assumption, the court agreed with the taxpayer's position that no disguised sale of property occurred. It also remained convinced that Otey had been decided correctly.

With respect to the disguised sale issue, the court applied the same approach it used in Otey by reviewing the facts and circumstances to determine whether the substance of the transactions was in accordance with their form pursuant to Treas. Reg. §§ 1.707-1(a), 1.721-1(a), and 1.731-1(c)(3). The court found the following facts persuasive: (i) the form of the transactions was a contribution followed by a distribution (rather than a sale), and (ii) at the time the land was contributed, the distribution of cash back to the taxpayer was contingent due to the

fact that the partnership had not consummated the sale transactions from which the cash was generated.

The Service later acquiesced in Park Realty. See IRS AOD 1982-67, 1982 WL 212496 (Aug. 2, 1982). Although the Service restated that it disagreed with Otey due to the fact that the source of the distribution proceeds in Otey was the other partner, the Service concluded that Park Realty was not a good case in which to attempt to overrule Otey since the distribution proceeds originated from the partnership's sale of the contributed land to the future tenants (rather than originating from the other partner), which such sales were not certain at the time of the contribution of the land to the partnership (i.e., the taxpayer's right to a subsequent distribution was dependent on the entrepreneurial risks of the partnership for at least three months).

e. Jupiter Corp. v. United States, 2 Cl. Ct. 58 (1983) (no disguised sale of partnership interest)

(i) Facts

A real estate partnership was owned by a general partner with a 77.5 percent interest and a limited partner with a 22.5 percent interest. The general partner was obligated to supply the partnership with all funds in excess of a $20 million partnership loan. Pursuant to this obligation, the general partner loaned the partnership $4 million in 1964. In 1965, the general partner wanted additional capital contributed to help fund operations but did not want to lose management control over the partnership. New partners wanted to obtain 20 percent limited partner interests (in aggregate) that would entitle them to cumulative preferential rights to monthly distributions of income. To admit the new partners, the general partner needed the

consent of the existing limited partner. However, the existing limited partner did not want to reduce its interest. So, the general partner agreed to receive distributions sufficient to reduce its partnership interest to 57.5 percent. As a result, the partnership issued the 20 percent limited and preferred partner interests to the prospective partners at the same time the general partner's interest declined from 77.5 percent to 57.5 percent. In order to be admitted to the partnership, the new limited partners loaned $3.5 million and contributed roughly $1.1 million to the partnership. The partnership agreement required that the repayment of the loan proceeds and the payment of partnership income to the new partners be afforded priority over all other payments to all other partners. Shortly after the admission of the new partners, the partnership distributed the loan proceeds to the general partner in satisfaction of the general partner's loan to the partnership and distributed the contributed capital to the general partner and existing limited partner in accordance with their pre-admission interests.

(ii) Relevant Arguments

The government argued that, under Treas. Reg. § 1.731-1(c)(3), the contributions and distributions should be treated as a sale of 20 percent of the general partner's interest in the partnership to the new limited partners. The general partner argued that the contributions and distributions fell under sections 721 and 731, respectively.

(iii) Ruling

The Claims Court recognized the following principles. First, citing Foxman v. Commissioner, 41 T.C. 535 (1964), and the legislative history of the partnership provisions of the Code, the court provided that the Code gives a partner flexibility to choose either to sell his

partnership interest to a third person or to reorganize the partnership to allow the admission of the third person as a new partner. Second, citing CSC and Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971) (discussed below), the court provided that the major limitation on this flexibility is that the substance of the transaction (as evidenced by the true intent of all the parties) must comport with the form of the transaction. The court then applied a facts and circumstances test to determine the true intent of the parties. The court found that the parties did not intend that the transactions constitute a disguised sale of a partnership interest from the general partner to the new limited partners, because (i) there was no evidence that the parties had chosen the form of the transactions to yield better tax results, (ii) the type of limited partner interest the new partners wanted (i.e., preferred interests) did not exist prior to their admission (so, the existing partners could not have sold such an interest to the new partners even if they had wished to do so), (iii) the type of partnership interest the general partner had was not the type that he wanted to sell (or that the limited partners wanted to purchase) since the general partner did not want to share his management rights with another general partner (and the new limited partners did not want to manage the partnership), (iv) the existing limited partner received a portion of the capital contributed by the new limited partners rather than the general partner receiving all the contributed capital, and (v) the existing limited partner's obligations and rights with respect to the partnership had been modified as a result of the admission of the new limited partners (e.g., the pre-existing limited partner was granted future property rights held by the partnership and was relieved of certain obligations to contribute capital to the partnership). The court stated further: "The economic and legal pre-requisites of [the general partners] and the [limited partners] mandated that the partnership be reorganized to admit the [limited partners] as new limited partners. . . . The transaction involved in this case was not 'a camouflaged sale of a

partnership interest.' *Cf. Crenshaw v. United States*, 450 F.2d 472, 476 (5th Cir. 1971). The parties had legitimate business reasons for structuring the transaction as they did. In fact, the goals sought by the parties could not have been achieved by structuring the transaction as a sale of a portion of [the general partner's] partnership interest."

f. Oehlschlager v. Commissioner, 55 T.C.M. (CCH) 839 (1988)

(i) Facts

A limited partnership was formed to develop a new energy conversion process. The partnership originally had 8 individual partners and had incurred a recourse liability to help pay for development costs. On December 21, 1982, the partnership admitted 27 new individual partners in order to raise additional funds to continue the development of the energy conversion process. The 27 new individual partners, including the petitioner, contributed an aggregate of $600,000 to the partnership in exchange for class B limited partner interests in the partnership, which represented an aggregate majority interest in the capital and profits of the partnership. At the same time, the original 8 partners converted their interests into class A limited partner interests in the partnership. One of the purposes of the admission of the class B limited partners was to pay the recourse liability of the partnership on which the class A limited partners were liable. On December 30, 1982, the partnership paid its recourse liability in full, thereby extinguishing the liability of the class A limited partners. On the same date, the partnership incurred another liability that only the class B limited partners assumed. In 1983, the class B limited partners made additional cash contributions. Shortly after such contributions, the class A limited partners were repaid their original capital contributions.

(ii) Relevant Arguments

The Commissioner issued a deficiency notice to the petitioner (i.e., one of the class B limited partners) with respect to the petitioner's claimed amount of loss from the partnership for the calendar year 1982. The petitioner argued that he was not the proper person to have received the deficiency notice. Rather, the partnership was the proper person under the newly-enacted unified partnership audit and litigation provisions of the Code (i.e., sections 6221 to 6234), since the taxable year at issue began after September 3, 1982 (i.e., the effective date of the unified partnership audit and litigation provisions of the Code). The petitioner argued, pursuant to Treas. Reg. §§ 1.721-1(a) and 1.731-1(c)(3), that the admission of the class B limited partners followed by the repayment of the recourse liability of the partnership and the repayment of the class A limited partners' original contributions constituted a disguised sale of 50 percent or more of the total interest in capital and profits of the partnership from the class A limited partners to the class B limited partners, thereby causing a new taxable year of the partnership to begin on December 21, 1982, under sections 706(c) and 708(b)(1)(B). Under this argument, the short taxable year beginning December 21, 1982, included the loss that was being challenged by the Commissioner and constituted a taxable year of the partnership that was governed by the unified partnership audit and litigation provisions of the Code. Thus, since no deficiency notice had been sent to the partnership, the petitioner argued that the court lacked jurisdiction over the determination of the proper amount of partnership loss. The Commissioner argued that no disguised sale occurred, and, therefore, the taxable year of the partnership that included the loss at issue was not governed by the unified partnership audit and litigation provisions of the Code.

(iii) Ruling

The Tax Court failed to find a disguised sale. The court's opinion opened with the following statement about the application of Treas. Reg. § 1.731-1(c)(3): "While it is sometimes difficult to discern the distinction between a sale or exchange of partnership interests and a change in ownership percentages resulting either from the admission of new partners or from the shifting of percentage interests among existing partners, one key factor in making the distinction is whether the property or cash transferred to obtain an increased partnership percentage in substance becomes a partnership asset. The purpose of section 1.731-1(c)(3), Income Tax Regs., is to preserve the reality of the distinction between exchanges and mere shifts in interests by precluding partners from denominating a sale or exchange of their interests as a contribution of property followed by a distribution to the selling partner. See also section 1.721-1(a), Income Tax Regs. If the partnership has only a fleeting interest in the contributed asset that is distributed to a partner resulting in a diminished partnership interest, the transaction in substance seems to be an exchange of the partnership interest for the property received in distribution. The regulation does not, of course, require that every partnership distribution following a contribution of property be treated as an exchange. The regulation balances the desirability of preserving the tax consequences chosen by the partners with the need to assure that the correct tax consequences indeed flow from the transaction that occurred. Exchange treatment is required if the partners *intended* 'to effect an exchange of property between two or more of the partners or between the partnership and a partner.' Section 1.731-1(c)(3), Income Tax Regs.; *cf. Otey v. Commissioner*, 70 T.C. 312 (1978), *aff'd per curiam*, 634 F.2d 1046 (6th Cir. 1980). Such a determination is inherently factual and, consequently, is not easily susceptible of sure and fast resolution. Nevertheless, . . . the Court must discern the intentions of the

partners from objective factual implications rather than from an arithmetically applied deemed sale rule." (Some internal citations omitted).

The court noted that, in order for the petitioner to prevail, strong proof of a disguised sale of partnership interests had to be presented since the petitioners were arguing against the form of the transaction. The court concluded that the petitioner had failed to produce such strong proof, and the objective facts actually indicated that the class B limited partners intended their transfers of cash to the partnership to be treated as a contribution to capital. The court found that the following facts supported its conclusion: (i) the partners and the partnership failed to report for Federal income tax purposes that there were two short taxable years during the 1982 calendar year, (ii) the class A limited partners did not relinquish all of their interests in partnership capital and profits, and (iii) although the class A limited partners were deemed to received cash distributions upon the recourse liability's retirement under section 752, "the deemed distribution requirement serves to adjust the basis of a partnership interest and not necessarily to substitute for an actual receipt of partnership property for purposes of the deemed exchange rule of the regulations [i.e., Treas. Reg. § 1.731-1(c)(3)].".

2. Case Law Finding a Disguised Sale

a. Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971) (disguised sale of partnership interest)

(i) Facts

The taxpayer ("Wilson") was a partner in a real estate partnership with Mr. Blair ("Blair"), among others. Wilson was also the executor of her husband's estate, which owned real

estate. Blair wanted to buy Wilson's partnership interest for cash. However, Wilson's tax attorney dissuaded Wilson from selling her partnership interest to Blair. Instead, the parties engaged in the following transactions (presumably all on the same day) to accomplish the same goal: (i) Wilson received a liquidating distribution from the partnership of a portion of real estate (the "Pine real estate"), (ii) Wilson exchanged the Pine real estate for like-kind real estate from her husband's estate, (iii) Wilson, as executor of her husband's estate, sold the Pine real estate for $200,000 to Blair's wholly-owned corporation, and (iv) Blair's wholly-owned corporation contributed the Pine real estate back to the partnership in exchange for a partnership interest.

(ii) Relevant Arguments

The government argued that the substance of the transactions was merely a sale of Wilson's partnership interest to Blair for $200,000 followed by an exchange of the $200,000 for the real estate held by the estate of Wilson's husband, and, therefore, Wilson should be taxed in accordance with the substance of the transactions. Wilson argued that she had the right to structure her transactions in any lawful way that minimized her tax burden, and, thus, the transactions should be tax-free to her under sections 731 and 1031.

(iii) Ruling

The Fifth Circuit recognized two guiding principles. First, the substance of a transaction prevails over its form. "[A]s has long been recognized, the substance rather than the form of a transaction determines its tax consequences, particularly if the form is merely a convenient device for accomplishing indirectly what could not have been achieved by the

selection of a more straightforward route. ‘To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.’ Commissioner of Internal Revenue v. Court Holding Co., 324 U.S. 331, 334, 65 S.Ct. 707, 708, 89 L.Ed. 981, 985 (1945). Transparent devices totally devoid of any non-tax significance to the parties cannot pass muster even though a literal reading of the statutory language might suggest otherwise. Commissioner of Internal Revenue v. P. G. Lake Inc., 356 U.S. 260, 266-267, 78 S.Ct. 691, 695-696, 2 L.Ed.2d 743, 749 (1958). The tax policy of the United States is concerned with realities rather than appearances, and when an illusory facade is constructed solely for the purpose of avoiding a tax burden the astute taxpayer cannot thereafter claim that a court is bound to treat it as being a genuine business arrangement. See Casner v. Commissioner of Internal Revenue, 450 F.2d 379 (5th Cir. 1971).” Second, the tax consequences of an interrelated series of transactions are not to be determined by viewing each of them in isolation but by considering them together as component parts of an overall plan.

The court framed the issue in light of these principles as follows: “Here the successful application of these principles depends upon a showing by the Government that, while in form these transfers may appear to be no more than a liquidation of a partnership interest followed by a tax-free § 1031 exchange, in substance they are really nothing more than a camouflaged sale of a partnership interest masquerading as a liquidation. But in order to reach this conclusion it must be shown that the character of the transaction is in every respect, other than the superficial and irrelevant one of form, a sale, resulting in precisely those consequences that would have occurred had Taxpayer simply sold her interest in the partnership to the partnership or to the surviving partners for $200,000 cash and then purchased with that money

her income-producing property. And it would be an equivalent transaction if the relative positions of the parties following this well-engineered series of exchanges was for all practical purposes substantially the same as it would have been had they chosen the direct rather than the circuitous route."

The court then analyzed the facts and circumstances to rule that the transactions should be recharacterized as a sale of Wilson's partnership interest to Blair followed by Wilson purchasing the real estate from her husband's estate. The court focused on the following items: (i) despite the labels attached, the parties intended a sale of Wilson's partnership interest, (ii) at the end of all the transactions, Blair (through his alter ego corporation) had acquired the same partnership interest he would have acquired had he purchased Wilson's interest, (iii) the Pine real estate started and ended in the partnership, (iv) at the end of all the transactions, Wilson had the same interest in the partnership (i.e., zero) as she would have had if she had sold her interest to Blair, and (v) the parties failed to show "any conceivable legitimate business purpose" for the chosen form of the transactions.

The court also noted: "Our conclusion is not affected by the undisputed fact that Taxpayer disposed of her entire partnership interest rather than a portion of it. . . . Nor do we overlook Taxpayer's clearly correct contention that Congress, in enacting these provisions, has provided an individual with alternative methods for divesting himself of a partnership interest. See Foxman v. Commissioner of Internal Revenue, 352 F.2d 466 (3d. Cir. 1965); Paul J. Kelly, 29 T.C.M. 1090 (1970); Andrew O. Stilwell, 46 T.C. 247 (1966). Taxpayers have a choice between selling and liquidating. But they cannot compel a court to characterize the transaction solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status."

b. Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793 (1988) (disguised sale of partnership interest)

(i) Facts

Colonnade, a corporation, owned roughly a 51 percent general partner interest in a limited partnership, GK. Colonnade was owned by B, F, and M. In 1978, GK amended its partnership agreement to admit B, F, and M into GK as general partners. As a result of their admission, Colonnade's interest in the partnership decreased from roughly 51 percent to 10 percent, and B, F, and M each acquired 13.66 percent interests. In addition, B, F, and M assumed a portion of Colonnade's pre-existing obligation to make capital contributions to GK. No changes were made to the interests of the other pre-existing partners of GK. GK had pre-existing non-recourse liabilities in which Colonnade's share declined from roughly 51 percent to 10 percent and the shares of B, F, and M increased to 13.66 percent each.

(ii) Relevant Arguments

The Commissioner argued that the 1978 amendment to the partnership agreement of GK resulted in a sale of roughly a 41 percent interest in GK held by Colonnade to B, F, and M in exchange for the relief of partnership-level liabilities. Colonnade argued that the 1978 amendment to the partnership agreement merely resulted in B, F, and M entering GK via tax-free transfers of capital under section 721, and the shift of partnership-level debt from Colonnade to the entering partners merely resulted in a tax-free distribution of cash from GK to Colonnade under sections 731 and 752(b).

(iii) Ruling

The Tax Court introduced its ruling by stating that the Code provides flexibility to partners by permitting them to choose either to sell their partnership interests to a third person or to reorganize the partnership to allow the admission of a third person as a new partner. Citing Gregory v. Helvering, 293 U.S. 465 (1935), Commissioner v. Court Holding Co., 324 U.S. 331 (1945), Crenshaw, and Jupiter, the court cautioned, however, that this flexibility is limited by the fact that the form of a transaction must be in keeping with its true substance and the intent of the parties. The court then recognized that the Code and Treasury regulations do not provide any guidance in distinguishing between an admission of new partners and a sale of a partnership interest.

The court applied a facts and circumstances test to determine the substance of the transaction at issue and concluded that the substance of the 1978 amendment to the partnership agreement of GK was a sale of roughly a 41 percent interest in GK held by Colonnade to B, F, and M. The court focused on the following facts: (i) the partnership as a whole was unchanged by the admission of B, F, and M (i.e., there was no additional or new capital contributed to GK), (ii) the interests of the other partners of GK remained unchanged by the amendment, (iii) B, F, and M expressly assumed a portion of Colonnade's liability to contribute additional cash to GK in the future, (iv) a portion of Colonnade's share of the partnership-level non-recourse liabilities was shifted to B, F, and M, (v) the partnership interest acquired by B, F, and M was the same type of partnership interest that Colonnade owned prior to the transaction, and (vi) the fact that the relevant documentation reflects a transaction between B, F, and M and the partnership – not Colonnade – is not controlling. With respect to liabilities, the court stated: "The fact that the

three shareholders of Colonnade expressly assumed Colonnade's liabilities, in return for partnership interests . . . is especially significant. In determining whether an actual or constructive sale or exchange took place, we note that the touchstone for sale or exchange treatment is consideration. . . . [W]e [have] noted that where liabilities are assumed as consideration for a partnership interest a sale or exchange exists[.]"

The court also found that Jupiter and CSC involved similar issues but were factually distinguishable from this case. Unlike in Jupiter, the partnership interest that B, F, and M acquired was the same type of partnership interest that Colonnade owned. Unlike in Jupiter, the rights and obligations of the other pre-existing partners were unaffected. Unlike in CSC, GK was organized and operated for the financial benefit of the partners rather than to further a common worldwide objective. Note that the court addressed section 707(a)(2)(B) (discussed below) in a footnote but did not apply it since the relevant transactions occurred prior to the effective date of the statute.

c. Jacobson v. Commissioner, 96 T.C. 577 (1991), aff'd per curiam, 963 F.2d 218 (8th Cir. 1992) (disguised sale of property)

(i) Facts

A general partnership ("JWC") owned real property. For the two years prior to 1982, JWC had been trying to sell the real property. In 1982, JWC was introduced to an insurance company ("M") that was willing to enter into a transaction that effectively transferred 75 percent of the real property to M in exchange for cash. JWC and M, with the help of their tax attorneys, consummated the following transaction in 1982. JWC contributed 100 percent of the real property to a new general partnership in exchange for a 25 percent interest in the

partnership. At the same time, M contributed cash equal to 75 percent of the fair market value of the real property to the partnership in exchange for a 75 percent interest in the partnership. Immediately thereafter, the partnership distributed all of the contributed cash to JWC. The audited financial statements for JWC described the transactions as a sale of 75 percent of the real property from JWC to M followed by JWC and M contributing their respective interests in the real property to the partnership. However, the audited financial statements of the partnership described the transactions as a contribution of 100 percent of the real property from JWC followed by a distribution of cash from the partnership.

(ii) Relevant Arguments

The Commissioner argued that the contribution of real property followed by the distribution of cash constituted a disguised sale of 75 percent of the real property from JWC to M followed by JWC and M contributing 25 percent and 75 percent of the real property, respectively, to the partnership. The Commissioner also appeared to argue in the alternative that the contribution and distribution should be treated as a disguised sale of 75 percent of the real property from JWC to the partnership under section 707(a). The partners of JWC argued that the contribution and distribution should be tax-free under sections 721 and 731, respectively.

(iii) Ruling

The Tax Court agreed with the Commissioner's primary argument and held that the contribution and distribution should be treated as a disguised sale of 75 percent of the real property from JWC to M followed by JWC and M contributing 25 percent and 75 percent of the real property, respectively, to the partnership.

The court initially recognized that Congress had enacted section 707(a)(2)(B) (discussed below) and expressed disapproval with Otey in the legislative history of section 707(a)(2)(B). In the face of this legislative history, the court declined to overrule Otey and remained "convinced that [its] analysis [in Otey was] correct for property transferred before the effective date of section 707(a)(2)(B)." It declined to discuss whether the analysis in Otey was appropriate in applying section 707(a)(2)(B).

The court then applied the same analysis that it had in Otey. Thus, the court determined whether the substance of the transactions comported with their form by reviewing all the facts and circumstances. Citing Gregory v. Helvering, 293 U.S. 465 (1934), the court ruled that, in determining the substance of the transactions, the existence or lack of a non-tax business purpose was crucial. "[I]n order for the nonrecognition provisions of section 721 and 731 to apply in this case, there must have been a valid business purpose (or purposes) supporting the contribution . . . and the distribution . . . ." In a footnote, the court further stated that, although in Otey and its progeny the court did not expressly state that it was applying a business purpose requirement, "the factors we have discussed [in such cases] represent facts which indicate the presence or absence of a valid business purpose."

The court found the following facts persuasive in concluding that the substance of the transactions was a sale of 75 percent of the real property from JWC to M: (i) JWC's only business purpose was to sell the real property for cash, (ii) JWC had attempted to sell the real property outright for the two years prior to the relevant transactions, (iii) there was no evidence that JWC had changed its intent to sell the real property outright, and (iv) the distributed funds originated with M rather than from a lender of the partnership or some other third party.

The Court of Appeals for the Eighth Circuit affirmed the Tax Court with little discussion. The Eighth Circuit did emphasize that the crucial difference between this case and Otey was the fact that, in this case, the distributee partner was not obligated to return the distributed funds if the partnership defaulted on its debts (i.e., the distributed cash originated from another partner's contribution) (unlike the distributee partner in Otey where a partnership debt was created to fund the cash distribution, and the distributee partner would be liable for the repayment of such debt if the partnership defaulted).

3. Case Law Unclear Regarding a Disguised Sale

a. Barenholtz v. Commissioner, 77 T.C. 85 (1981) (suggestion that disguised sale of property under alternative argument of Commissioner)

(i) Facts

The taxpayer was a real estate developer who owned certain real property. In May 1972, the taxpayer executed an agreement to sell to three individuals 25 percent of such real property to each individual in exchange for cash. One month later, the same parties entered into a partnership agreement, which called for each party to contribute the party's 25 percent interest in the real property in exchange for a 25 percent interest in the partnership. However, at the end of June 1972, the taxpayer transferred the deed to 100 percent of the property directly to the partnership (rather than partially to the other three individuals). The taxpayer reported the transactions on his Federal income tax return for 1972 as a sale of 75 percent of the real property for cash.

(ii) Relevant Arguments

The taxpayer argued that 100 percent of the real property actually had been contributed to the partnership in a transaction described in section 721(a), and the cash proceeds from the other individuals had been contributed by them to the partnership and then distributed to the taxpayer in a transaction described in section 731 in order to equalize the taxpayer's and the other individuals' capital accounts in the partnership. The Commissioner argued that the taxpayer sold 75 percent of the real property to the other three individuals, and, then, all the parties contributed their 25 percent interests in the real property to the partnership in transactions described in section 721(a). Alternatively, the Commissioner argued that, even if 100 percent of the real property is viewed as being contributed by the taxpayer, such contribution coupled with the related distribution of cash constituted a disguised sale of the real property to the partnership under section 707(a).

(iii) Ruling

The Tax Court accepted the Commissioner's primary argument. The court held the taxpayer to the form of the transactions due to the following facts and circumstances: (i) the sale agreement evidenced the intent of the taxpayer to sell 75 percent of the real property to the other three individuals, (ii) the taxpayer received consideration from the three individuals rather than from the partnership, (iii) the obligation to pay the taxpayer for the real property was assumed solely by the three individuals rather than by the partnership as well, and (iv) the transfer of the deed from the taxpayer directly to the partnership was done on behalf of the other three individuals as well (not solely on behalf of the taxpayer). In a footnote, the court, citing

Otey and Treas. Reg. §§ 1.721-1(a) and 1.731-1(c)(3), suggested that, even if the court accepted the taxpayer's characterization of the transactions, the fact that the cash received by the taxpayer ultimately came from the other three individuals (rather than from a partnership loan or some other source) would be a significant factor weighing toward disguised sale treatment. The court concluded by stating that, although the partnership rules of the Code were enacted to provide flexibility to partners in arranging their affairs in partnership form, a partner could not avoid the tax consequences flowing from transactions the form of which was chosen by the partner.

b. Mahoney v. United States, 48 A.F.T.R.2d 81-6131, 81-2 U.S.T.C. ¶ 9761 (Ct. Cl. 1981)

(i) Facts

A general partnership was formed in 1970 between two partners. In 1971 before August, the partnership incurred certain losses. On August 19, 1971, the partnership converted to a limited partnership and, pursuant to a limited partnership agreement, admitted two limited partners in exchange for cash contributions, which were distributed to the general partners three days later. Under the limited partnership agreement, the limited partners were entitled to 100 percent of the partnership income until their capital contributions were recovered and 50 percent thereafter. Further, upon liquidation, the limited partners were entitled to receive their contributions first less any capital distribution and, then, 50 percent of the remaining partnership assets. As part of the limited partners' claimed distributive shares of losses from the partnership for 1971, the limited partners included the certain losses incurred by the partnership prior to their admission.

(ii) Relevant Arguments

The United States argued, in part, that, on the date of the admission of the limited partners, the partnership terminated under section 708(b)(1)(B), since the contribution of cash by the limited partners followed three days later by the distribution of such cash to the general partners pursuant to the limited partnership agreement constituted a disguised sale of partnership interests from the general partners to the limited partners under Treas. Reg. § 1.731-1(c)(3). As a result, under this argument, the taxable year of the partnership closed on such date, thereby prohibiting the limited partners from sharing in the partnership losses incurred prior to such date in 1971. The limited partners argued that the contributions and distributions did not constitute disguised sales and were governed by sections 721 and 731, respectively.

(iii) Ruling

The Court of Claims was faced with opposing motions for summary judgment on the disguised sale issue. The court declined to find as a matter of law that a disguised sale of partnership interests occurred. However, the court concluded that the substance of the transactions "might" constitute disguised sales of partnership interests, but more facts surrounding the transactions were needed to determine the true nature of the transactions. The court distinguished CSC by noting that, unlike the existing partners in CSC, the general partners were motivated by financial considerations (not by a desire to foster international comity).

III. Direct Statutory Guidance - Section 707(a)(2)(B)

A. Section 707(a)(2)(B)

Presumably in response to some of the above case law that declined to find disguised sales, Congress enacted section 707(a)(2)(B) in the Deficit Reduction Act of 1984, P.L. No. 98-369. Section 707(a)(2)(B) reads: "Under regulations prescribed by the Secretary-- . . . If (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated as a transaction [between the partnership and a partner not in its capacity as a partner] or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership." (Emphasis added).

B. Legislative History

The legislative history of section 707(a)(2)(B) evidenced a belief by Congress that, despite Treas. Reg. §§ 1.721-1(a) and 1.731-1(c)(3), case law, such as Otey, CSC, and Jupiter, effectively permitted partners to defer or avoid tax on partnership transactions that were "economically indistinguishable from a sale of all or part of the property." See S. Rep. No. 98-169 (1984); H.R. Conf. Rep. No. 98-861 (1984); H. Rep. No. 98-432 (1984). The Senate and House reports explicitly cite Otey, CSC, and Jupiter.

Of particular note, the legislative history evidences an intent by Congress that the purposes of section 707(a)(2)(B) would be carried out by issuing Treasury regulations. Also, the

legislative history suggests that the shifting of pre-existing partnership-level debt should not be taken into account in addressing a disguised sale issue.

C. Relevant Excerpts

1. Senate Report

> "*Present Law* . . . [B]ased on these regulations [(i.e., Treas. Reg. §§ 1.721-1(a) and 1.731-1(c)(3))], the Internal Revenue Service has argued that a contribution of cash by one partner followed by a distribution of cash to another partner should be recharacterized as a sale of an interest in the partnership. The rules above [(i.e., sections 721 and 731 and Treas. Reg. §§ 1.721-1(a) and 1.731-1(c)(3))] may not always prevent de facto sales of property to a partnership or another partner from being structured as a contribution to the partnership, followed (or preceded) by a tax-free distribution from, the partnership. For example, under the case law, partner A may contribute $50,000 in cash to a partnership and partner B may contribute property with a basis of $50,000 and a fair market value of $100,000 to the partnership as an equal partnership. If the partnership then transfers $50,000 in cash to partner B, based on the case law, it would not be unreasonable for partner B to claim that this $50,000 represents a distribution not exceeding his basis in the partnership and for which he is therefore not subject to tax. (The basis for partner B's

interest in the partnership would then be reduced from $50,000 to $0.) If this result is permitted, partner B has deferred or avoided tax on a transaction which closely resembles a sale of property to the partnership (or a partial sale to partner A followed by a joint contribution). Case law has permitted this result, despite the regulations described above, in cases which are economically indistinguishable from a sale of all or part of the property. *See Otey v. Commissioner, 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (1980); Communications Satellite Corp. v. United States, 223 Ct. Cl. 253 (1980); Jupiter Corp. v. United States, No. 83-842 (Ct. Cl. 1983). . . .*

Reasons for Change . . . . In the case of disguised sales, the committee is concerned that taxpayers have deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed (or preceded) by a related partnership distribution. Although Treasury regulations provide that the substance of the transaction should govern, court decisions have allowed tax-free treatment in cases which are economically indistinguishable from sales of property to a partnership or another partner. The committee believes that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. . . .

Explanation of Provisions . . . . The bill provides that when a partner transfers money or other property to a partnership which when viewed in connection with a related direct or indirect transfer of money or other property to that partner or another partner is properly characterized as a sale of property, the transaction is to be treated (as appropriate) as a sale between the partners of property (including partnership interests) or as a partial sale and partial contribution of the property to the partnership. The selling partner will be required to recognize gain (or loss) on the amount of the sales proceeds treated as received in the transaction. This rule is intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership to defer or avoid tax on the transaction.

To accomplish this, the bill authorizes the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this provision. In prescribing these regulations, the Treasury should be mindful that the committee is concerned with transactions that attempt to disguise a sale of property and not with non-abusive transactions that reflect the various economic contributions of the partners. Similarly, the committee does not intend to change the general rules concerning the tax treatment of the partners under sections

721, 731, and 752 to the extent (1) contributed property is encumbered by liabilities not incurred in anticipation of the contribution, or (2) contributions to a partnership which, because of liabilities of the partnership incurred other than in anticipation of the contribution, result in a deemed distribution under sec. 752(b).

It is anticipated that the regulations will apply the provision when the transfer of money or property from the partnership to the partner is related to the transfer of money or other property to the partnership in such manner that, taking into account all the facts and circumstances, the transaction substantially resembles a sale or exchange of all or part of the property (including an interest in the partnership). For example, when a partner contributes appreciated property to a partnership and receives a distribution of money or property within a reasonable period before or after such contribution, that is approximately equal in value to the portion of contributed property that is in effect given up to the other partner(s) the transaction will be subject to this provision. However, the distribution would not be so subject if there is a corresponding partnership allocation of income or gain . . . . The disguised sale provision also will apply to the extent (1) the transferor partner receives the proceeds of a loan related to the property to the extent responsibility for the repayment of the loan

rests, directly or indirectly, with the partnership (or its assets) or the other partners, or (2) the partner has received a loan related to the property in anticipation of the transaction and responsibility for repayment of the loan is transferred, directly or indirectly, to the partnership (or its assets) or the other partners.

Although the rule applies to sales of property to the partnership, the committee does not intend to prohibit a partner from receiving a partnership interest in return for contributing property which entitles him to priorities or preferences as to distributions, but is not in substance a disguised sale. Similarly, the committee generally does not intend this provision to adversely affect distributions that create deficit capital accounts (maintained in a manner consistent with Treasury regulations under section 704(b)) for which the distributee is liable, regardless of the timing of the distribution, unless such deficit capital account is improperly understated or not expected to be made up until such a distant point in the future that its present value is small. . . . Similarly, the contribution of encumbered property to a partnership would not suggest a disguised sale to the extent responsibility for the debt is not shifted, directly or indirectly, to the partnership (or its assets) or to the non-contributing partners. The committee anticipates that the Treasury regulations will treat transactions to which the provision applies as a sale of property or partnership interests

> among the partners or as a partial sale and partial contribution of the property to the partnership, with attendant tax consequences, depending upon the underlying economic substance of the transaction. These regulations may provide for a period, such as three years, during which contributions by and distributions to the same or another partner normally will be presumed related. Finally, it is anticipated that the regulations will take into account the effect of liabilities which may accompany effective sales of property to a partnership or another partner.
>
> No inference regarding the tax treatment of contribution arrangements or any similar transactions under existing law should be drawn from the committee's action."

S. Rep. No. 98-169 (1984).

2. House Report

The House report, although not as extensive as the Senate report, is in all material respects similar to the Senate report. See H. Rep. No. 98-432 (1984).

3. House Conference Report

> "*Present Law* . . . . [T]axpayers have deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed (or preceded) by a related distribution of partnership

> property (including money). Although Treasury regulations provide that the substance of the transaction should govern in these latter cases, court decisions have allowed tax-free treatment in cases which are economically indistinguishable from sales of property by the partner to a partnership or to another partner. . . .
>
> *Conference Agreement* . . . . The conferees wish to note that when a partner of a partnership contributes property to the partnership and that property is borrowed against, pledged as collateral for a loan, or otherwise refinanced, and the proceeds of the loan are distributed to the contributing partner, there will be no disguised sale under the provision to the extent the contributing partner, in substance, retains liability for repayment of the borrowed amounts (i.e., to the extent the other partners have no direct or indirect risk of loss with respect to such amounts) since, in effect, the partner has simply borrowed through the partnership. However, to the extent the other partners directly or indirectly bear the risk of loss with respect to the borrowed amounts, this may constitute a payment to the contributing partner."

H.R. Conf. Rep. No. 98-861 (1984). Note that, although the House and Senate reports cite Otey as a case where the contribution of property and the distribution of cash are economically indistinguishable from a sale of all or part of the property to the partnership, the Conference Report effectively states that section 707(a)(2)(B) would not have changed the result in Otey.

4. Joint Committee on Taxation Blue Book

The General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (the "1984 Blue Book"), prepared by the staff of the Joint Committee on Taxation, is in all material respects similar to the Senate report, except for the following additional guidance:

> "*Explanation of Provisions* . . . . *Disguised Sales* . . . . [F]urther factors indicating the existence of a disguised sale include the closeness in time of the distribution to the partner and the purported contribution of property by that partner, and the apparent tax motivation of the contributor of property in structuring the transaction as a contribution of property to the partnership. However, the existence of significant non-tax motivations for becoming a partner is of no particular relevance in establishing that a transaction is not a disguised sale."

JCS-41-84 (Dec. 31, 1984). However, note that the property regulations appear (as did the proposed interest regulations) to take the position that the 1984 Blue Book does not constitute part of "the legislative history of [section 707(a)(2)(B)]." See Treas. Reg. § 1.707-9(a)(2); Former Prop. Treas. Reg. § 1.707-9(a)(2).

IV. Administrative Guidance on Disguised Sales of Property

After nearly seven years after the enactment of section 707(a)(2)(B), proposed Treasury regulations were published on April 25, 1991. See 56 Fed. Reg. 19,055-02 (Apr. 25, 1991). The final Treasury regulations were published on September 30, 1992. See 57 Fed. Reg. 44,974-01 (Sept. 30, 1992). The final Treasury regulations are discussed below in addressing the following:

a. Simultaneous transfers;

b. Nonsimultaneous transfers;

c. Mixing-Bowl transactions;

d. Contributions of encumbered property—treatment of qualified liabilities;

e. Contributions of encumbered property—treatment of nonqualified liabilities;

f. Guaranteed payments, preferred returns, and operating cash flow distributions;

g. Guaranteed payments and service partner;

h. Preferred return and pledge of partnership interest;

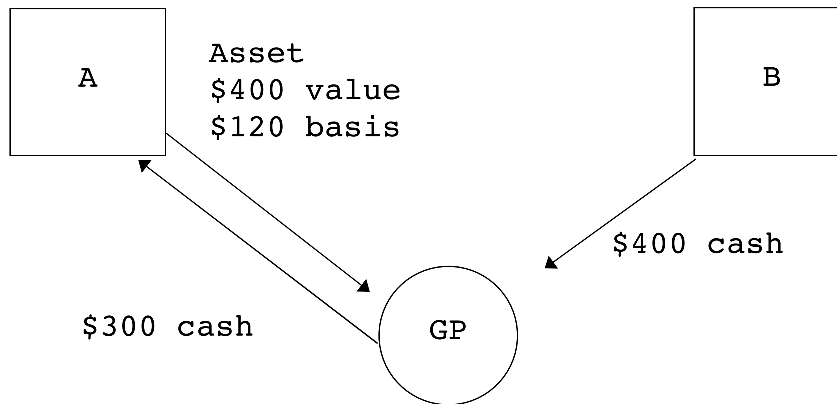
i. Use of cross-allocation only;

j. Treatment of transferees;

k. Preformation expenditures; and

l. Wrap-around contributions.

Simultaneous Transfers



1. A contributes an asset with a $400 value and a $120 basis to GP in exchange for a 20% interest. B contributes $400 cash to GP in exchange for an 80% interest. Immediately after the contributions, GP distributes $300 cash to A.

2. In the case of a simultaneous contribution and distribution, a disguised sale of property will be found if the facts and circumstances establish that the distribution to A would not have been made but for the contribution by A. Treas. Reg. § 1.707-3(b)(1)(i).

3. Because A is a newly admitted partner, it is likely that any distribution to A would not have been made "but for" the contribution (since absent A's contribution, A would not have become a partner).

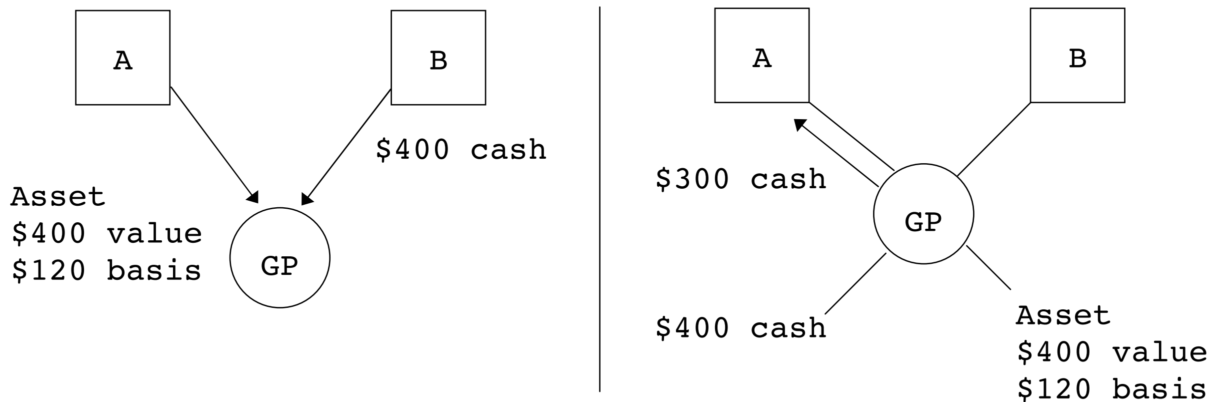
    a. Because the $300 distributed to A does not equal the $400 value of the contributed asset, A is considered to have sold a portion of the asset with a value of $300 to GP for $300 in cash. A must recognize a gain of $210 ($300 sales proceeds less $90 basis ($120 basis x ($300/$400))).

b. A is also treated as contributing to GP an asset with a value of $100 and a basis of $30. See Treas. Reg. § 1.707-3(f) ex. 1.

4. Sale treatment applies for all purposes of the Code, including sections 453, 483, 1001, 1012, 1031, and 1274. Treas. Reg. § 1.707-3(a)(2). Thus, in the above example, if GP instead had distributed property to A, and the requirements of section 1031 were met, the transaction may have been treated as a tax-free exchange under section 1031.

5. If A had been an existing partner, disguised sale treatment would not necessarily have been triggered. If the $300 distribution to A derived from sales proceeds of property that GP intended to sell regardless of A's contribution, the "but for" test would not have been met. See Treas. Reg. § 1.707-3(f) ex. 4.

Partnership Disguised Sale Rules:
Nonsimultaneous Transfers



1. A contributes an asset with a $400 value and a $120 basis to GP for a 20% interest. B contributes $400 cash to GP for an 80% interest. The partnership agreement provides that nine months after formation, GP must distribute $300 to A, and that, if GP does not have the $300, B is to makeup the shortfall with additional capital contributions.

2. Nine months after its formation, GP distributes $300 to A.

3. The above transactions would likely be treated as a disguised sale of A's asset to GP.

   a. Where a contribution and distribution are not simultaneous, the transfers will be treated as a sale if the facts and circumstances indicate that (1) the transfer of money or other consideration would not have been made but for the transfer of the property, and (2) the distribution was not dependent on the "entrepreneurial risks" of the partnership's operations. Treas. Reg. § 1.707-3(b)(1).

   b. Additionally, if within a two-year period there is a contribution by and distribution to a partner, the transfers are presumed to be a sale of the property to the partnership. This presumption is rebuttable only if "the facts and

circumstances clearly establish that the transfers do not constitute a sale." Treas. Reg. § 1.707-3(c)(1).

c. Given the facts and circumstances that (1) the partnership agreement requires that money be distributed to A nine months after GP's formation and (2) B is required to make up any shortfall with additional capital contributions, and given that the transfers fall within the two-year rule and are presumed to be a sale of the property, the transfers likely would be treated as a disguised sale.

4. If the transfers are treated as a disguised sale, A would be deemed to sell the property to GP on the date it was contributed to GP. GP would be treated as issuing to A an obligation to transfer $300. Treas. Reg. § 1.707-3(a)(2).

a. The rules of section 1274 (or section 1274A or section 483) would apply to impute interest in connection with the obligation.

b. If the disguised sale qualifies under the installment sales rules, section 453 would apply to the obligation. The section 453A interest charge on the deferred tax liability may also apply.

5. If the contribution by and distribution to A were more than two years apart, the transfers would be presumed not to be a sale of the contributed property, "unless the facts and circumstances clearly establish that the transfers constitute a sale." Treas. Reg. § 1.707-3(d).

· The examples in the property regulations focus on the likelihood that the contributing partner will in fact receive a distribution and give little deference to the presumption that favors the taxpayer. See Treas. Reg. § 1.707-3(f) exs. 5-8.

6. The property regulations do not contain any provisions regarding their application to transferees of partnership interests. Thus, A could attempt to avoid the disguised sale rules, after contributing the asset to GP, by selling its partnership interest on the installment method to X, an S corporation wholly owned by A. Thereafter, GP distributes $300 to X.

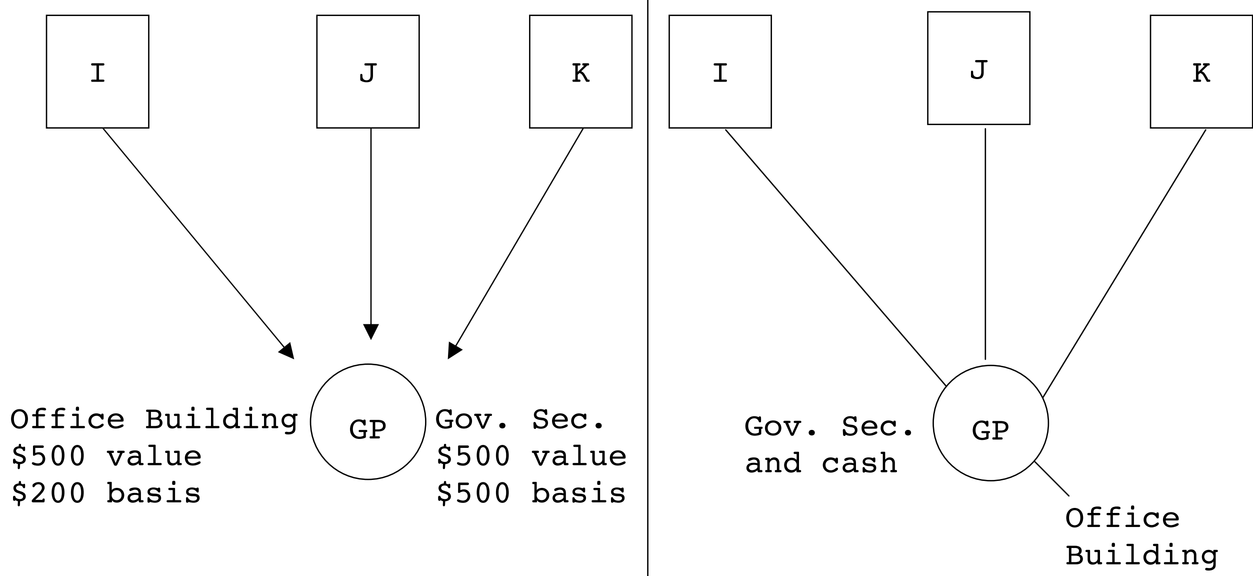
   a. Because X made no contribution of property to GP, the distribution arguably should not be treated as part of a disguised sale. See Treas. Reg. § 1.707-3(a)(1) ("if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in paragraph (b)(1) . . . the transfers are treated as a sale of property . . . .") (Emphasis added); but see section 707(a)(2)(B)(ii)(indicating that a disguised sale may occur if there is a transfer to the contributing partner or another partner).

   b. In the Preamble to the property regulations, the Service noted the absence of anti-abuse rules for specific situations, such as related-party transactions, but concluded that general tax principles adequately addressed issues of abuse. Thus, the Service may argue that the whole transaction should be treated as a sham or that X should "step into the shoes" of A, and therefore be subject to disguised sale treatment. Alternatively, the receipt of the $300 by X could be treated as a "second disposition" by X of property that was the subject of an installment sale, thereby triggering A's gain on the installment sale under section 453(e).

7. If interest is imputed under section 1274 on the partnership's deemed obligation to transfer $300 to A, will the capital accounts of the partners end up with different balances than the balances that would have existed if the form of the transaction were respected?

8. Assume that A transfers its asset to GP on September 1, 1992. Based on the facts existing at the time of the transfer, A concludes that "substantial authority" (within the meaning of section 6662) exists to report the transaction as a contribution governed by section 721. On June 1, 1994, A receives a distribution from GP that results in the transaction being presumed to be a sale. A concludes that it no longer has substantial authority to "clearly establish" that the transfer is not a sale and therefore the presumption cannot be rebutted. Does A have an obligation to file an amended return to report the transfer in 1992 as a sale?

Partnership Disguised Sale Rules:
Mixing-Bowl Transactions



1. The above diagrams are based on Example 8 in Treas. Reg. § 1.707-3(f), a so-called "mixing-bowl" transaction. I contributes to the partnership an office building with a $500 value and $200 basis that is almost fully leased on a long-term basis. J and K contribute government securities to the partnership with an aggregate value of $500 and basis of $500. All items of income, gain, loss, and deduction from the government securities are allocated, and cash flow from the securities is distributed, 90% to I and 10% to J and K; all such items from the office building are allocated and distributed 90% to J and K and 10% to I.

2. It is not expected that the partnership will need to resort to the government securities or the cash flow therefrom to operate the building. At the time the partnership is formed, the partners "contemplated" that I's interest in the partnership would be liquidated

sometime after the two-year presumption period ends in return for the government securities and, if necessary, cash.

3. Three years and one month after the partnership is formed, I's partnership interest is redeemed in exchange for the government securities and an amount of cash equal to the excess of I's 10% share of the appreciation in the office building over J and K's 10% share of the appreciation in the government securities since the formation of the partnership. The transaction avoids section 704(c)(1)(B).

4. Despite the presumption that the distribution to I was not part of a sale because it was made more than two years after I's contribution, the distribution is treated as a disguised sale payment under the property regulations. Two factors led to rebuttal of the favorable presumption: (1) the facts (including the amount and nature of the partnership's assets) indicated that at the time of I's contribution, the timing of the distribution of the government securities to I was anticipated and not subject to entrepreneurial risks, and (2) the partnership allocations were designed to effect an exchange of the burdens and benefits of ownership of the government securities in anticipation of their distribution to I and those benefits and burdens were effectively shifted to I on the formation of the partnership.

5. Should the transaction be treated as an installment sale? Does section 1274 apply to the transaction?

6. If I had contributed a high-risk asset to the partnership -- such as an unleased office building in a saturated market -- would there have been a "significant" risk that the partnership would have had to invade the government securities to operate the office building?

7. If J and K had contributed portfolio stock of high-risk companies, would the distribution of the stock to I have been subject to entrepreneurial risks?

8. If the partnership agreement in Example 8 had contained the 90/10 cross-allocations but no distributions (other than distributions of operating cash flow) were made during any relevant time frame, would a disguised sale have been found?

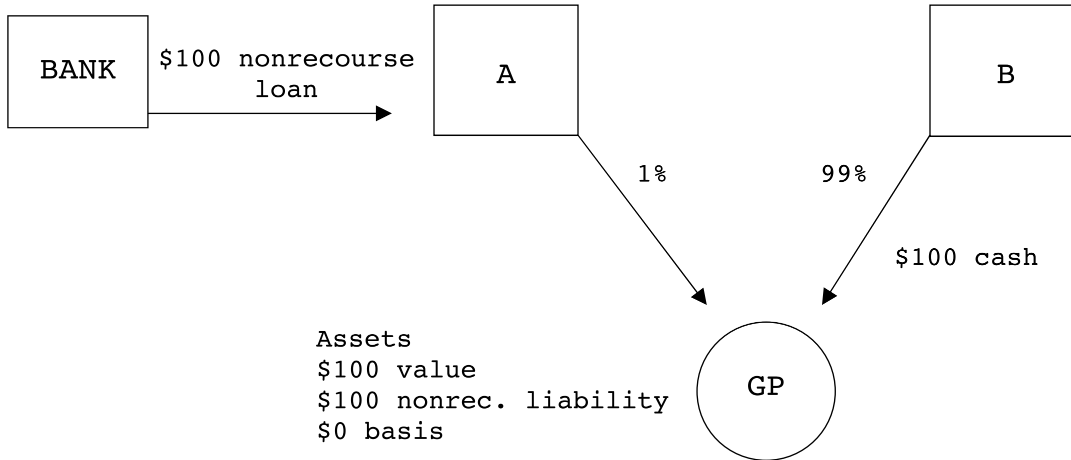
   a. What if the cross-allocations were 99/1?

   b. What if the cross-allocations were 90/10, but the partnership agreement provided that the government securities would be distributed to I after five years?

   c. What if the cross-allocations were 50/50 and the partnership agreement provided that the government securities would be distributed to I after two years?

9. What if due to an unexpected change in circumstances, the government securities are never distributed to I? Would GP be treated as issuing to I an installment obligation at the time of I's contribution of the office building and then defaulting on such obligation? Alternatively, would disguised sale treatment even apply?

Partnership Disguised Sale Rules:
Contributions of Encumbered Property
-- Treatment of Qualified Liabilities



1. A borrows $100 on a nonrecourse basis, secured by A's assets.

2. More than two years after the borrowing, A contributes assets to GP with a value of $100 and basis of $0. A keeps the $100 loan proceeds and GP assumes the nonrecourse liability. B contributes $100 in cash. Partnership allocations and distributions are 99/1 in B's favor.

3. Under the final regulations, "qualified liabilities" assumed or taken subject to in connection with a transfer of property to a partnership generally are not treated as part of a sale. This rule applies to both recourse and nonrecourse loans whether a partner or the partnership obtains the loans.

4. Four categories of liabilities are "qualified liabilities." Treas. Reg. § 1.707-5(a)(6)(i).

    a. First, a liability is a qualified liability if the liability was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property, provided such

liability encumbered the property throughout the two-year period. Treas. Reg. § 1.707-5(a)(6)(i)(A).

· Thus, A's liability assumed by GP is a qualified liability.

b. Second, a liability is a qualified liability if the liability was not incurred in anticipation of the transfer of the property to the partnership but was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership, provided such liability has encumbered the property since it was incurred. Treas. Reg. § 1.707-5(a)(6)(i)(B).

· However, a liability incurred within the two-year period is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer. Treas. Reg. § 1.707-5(a)(7)(i).

c. Third, a liability is a qualified liability if the liability is allocable under the interest-tracing rules of Treas. Reg. § 1.163-8T to capital expenditures with respect to the transferred property. Thus, acquisition or improvement debt constitutes a qualified liability. Treas. Reg. § 1.707-5(a)(6)(i)(C).

(i) The Service has advised that an intercompany loan between a corporation and its subsidiary is not a capital expenditure by the corporation with respect to the stock of the subsidiary under Treas. Reg. § 1.163-8T. As a result, if the corporation contributes stock of the subsidiary to a partnership and the partnership assumes debt allocated to the stock, the

debt assumed is not a "qualified liability" pursuant to Treas. Reg. § 1.707-5(a)(6)(i)(C) based upon the prior intercompany loan to the subsidiary. F.S.A. 200011025 (Dec. 16, 1999).

(ii) However, the Service advised that if (1) the corporation contributed cash or property to its subsidiary rather than making a loan, and (2) the subsidiary incurred and paid for capital expenditures that were traced to the contributed cash or property, then the subsidiary's capital expenditures would be considered capital expenditures with respect to the stock of the subsidiary. In turn, if the corporation then contributed stock of the subsidiary to the partnership and the partnership assumed debt allocated to the stock, the debt assumed would be a "qualified liability" pursuant to Treas. Reg. § 1.707-5(a)(6)(i)(C). Id.

d. Fourth, a liability is a qualified liability if the liability was incurred in the ordinary course of the trade or business in which the property contributed to the partnership was used or held, but only if all of the assets related to the trade or business are transferred, other than assets that are not material to a continuation of the trade or business. Treas. Reg. § 1.707-5(a)(6)(i)(D).

· The proposed regulations had adopted a slightly different approach, providing that a liability would be a qualified liability if the liability was incurred in the ordinary course of the trade or business in which the property contributed to the partnership was used or held, but only if substantially all of the assets used or held in such activity was contributed

to the partnership. Prop. Treas. Reg. § 1.707-5(a)(6)(i)(D), 56 Fed. Reg. 19,055, 19,067 (Apr. 25, 1991).

5. If a contribution of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership's assumption of or taking subject to a qualified liability in connection with the contribution of property will not be treated as part of a sale.

   a. If property encumbered by a qualified liability is contributed to a partnership in a transfer that is characterized as a disguised sale (for reasons other than the assumption of the qualified liability), the amount of the liability treated as consideration is the lesser of (1) the amount of consideration that the partnership would be treated as transferring to the partner had the liability constituted a nonqualified liability, or (2) the amount obtained by multiplying the amount of the qualified liability by the partner's "net equity percentage" with respect to the contributed property.

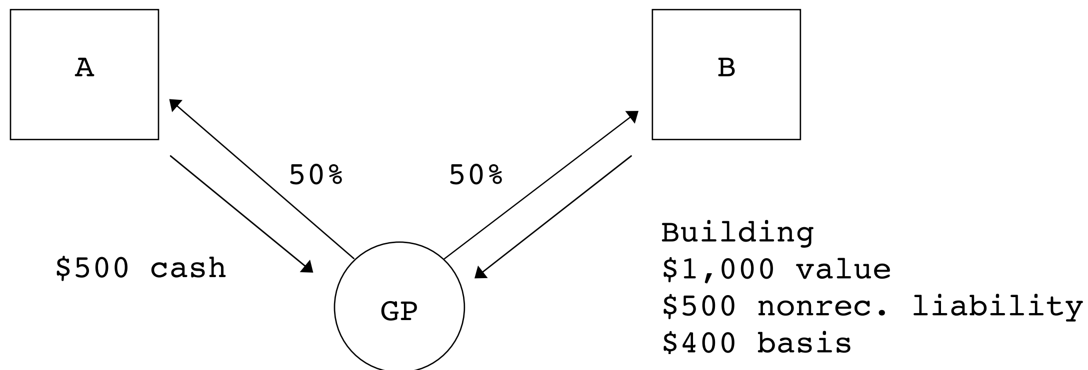
   b. A partner's "net equity percentage" with respect to an item of contributed property equals the percentage determined by dividing (1) the aggregate transfers of money or other consideration to the partner from the partnership (other than any transfer attributable to the qualified liability) that are treated as proceeds realized from the sale of the transferred property by (2) the excess of the fair market value of the contributed property at the time it is transferred to the partnership over any qualified liability encumbering the property (or, in the case of any qualified liability that is described in categories three and four above, that is properly allocable to the property). Treas. Reg. § 1.707-5(a)(5)(ii). Thus, under this formula, the portion of the "equity value" (i.e., the value in excess of the qualified

liability) that would be deemed sold without regard to the qualified liability determines the portion of the qualified liability that is treated as additional sales proceeds.

6. Under the section 453 regulations, if an installment purchaser assumes or takes subject to a liability that is not "qualifying indebtedness," the entire amount of the liability must be taken into account by the seller as payment in the year of sale. Treas. Reg. § 15A.453-1(b). It is entirely possible that "qualifying indebtedness" under the section 453 regulations will not constitute a "qualified liability" under the property regulations. For example, under the section 453 regulations, an unsecured liability will constitute "qualifying indebtedness" provided that it is not functionally unrelated to the acquisition, holding, or operating of the property or incurred in contemplation of the disposition of the property. Under Treas. Reg. § 1.707-5(a)(6)(i)(D), however, such a liability constitutes a "qualified liability" only if the liability was incurred in the ordinary course of the trade or business in which the property transferred to the partnership was used or held, and then only if all the assets related to the trade or business are transferred, other than assets that are not material to a continuation of the trade or business. If the unsecured liability was not incurred in contemplation of the transfer but also was not incurred in "the ordinary course," or if the property transferred was not used in any trade or business, or if less than all the assets related to the trade or business are transferred, other than assets that are not material to a continuation of the trade or business, the unsecured liability may constitute "qualified indebtedness" under the section 453 regulations but not a "qualified liability" under the property regulations. Given the similar purposes of the two sets of rules (to determine whether a liability was incurred in

contemplation of the disposition of the property), closer coordination of the rules would be desirable.

Partnership Disguised Sale Rules:
Contributions of Encumbered Property --
Treatment of Nonqualified Liabilities



1. In the case of a transfer of property in which the partnership assumes or takes subject to a liability other than a "qualified liability," the entire amount of the liability which is shifted to other partners is treated as an amount realized from a disguised sale, regardless of whether the partner receives any cash from the partnership. The rules for determining the portion of the liability treated as shifted to other partners depend on whether the liability is recourse or nonrecourse.

2. A partner's share of a liability that is a recourse liability equals the partner's share of the liability under the rules of section 752 and the regulations thereunder. Treas. Reg. § 1.707-5(a)(2)(i). Under the section 752 regulations, a partner's share of a recourse liability equals that portion of the liability for which such partner (or any person related to such partner) bears the economic risk of loss. See PLR 201103018 (taxpayer's transfer of assets and debt to LLC was not disguised sale of property under section 707(a)(2)(B); taxpayer transferred debt in excess of the value of the assets contributed; the entire debt would have constituted a qualified liability except that Treas. Reg. § 1.707-5(a)(6)(ii) treats recourse liabilities that exceed the value of the contributed property as a non-qualified liability; the Service permitted the debt to be bifurcated so that only the excess

debt constituted a non-qualified liability; since such excess debt was allocated entirely to the taxpayer, the Service concluded that there was no disguised sale consideration transferred to the taxpayer).

3. A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of excess nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3), which is the third-tier allocation rule. Treas. Reg. § 1.707-5(a)(2)(ii). The third-tier allocation rule provides that a partner's share of the excess nonrecourse liabilities, those not allocated under Treas. Reg. § 1.752-3(a)(1) and (2), are determined in accordance with the partner's share of partnership profits, taking into account all facts and circumstances. In the alternative, excess nonrecourse liabilities may be allocated in accordance with the manner in which deductions attributable to those liabilities will be allocated to the partners. Treas. Reg. § 1.752-3(a)(3). The final method for allocating excess nonrecourse liabilities (i.e., the excess section 704(c) method) is unavailable for disguised sale purposes. Id.

   a. Under the proposed property regulations, a partner's share of a nonrecourse liability was not determined under the section 752 regulations. Rather, a partner's share of a nonrecourse liability equaled the amount obtained by multiplying the outstanding balance of the liability by the partner's smallest percentage interest under the partnership agreement in any material item of income or gain that may be realized by the partnership for any taxable year from the property securing the payment of the liability. Prop. Treas. Reg. § 1.707-5(a)(2)(iii)(A), 56 Fed. Reg. 19,055, 19,066-67 (Apr. 25, 1991).

b. The Service modified the treatment of nonrecourse liabilities for purposes of simplicity. Preamble, T.D. 8439, 57 Fed. Reg. 44,974-01, 44,976 (Sept. 30, 1992).

4. The above diagram is based on Example 1 in Treas. Reg. § 1.707-5(f). A contributes $500 to GP. B contributes a building to GP with a value of $1,000 and basis of $400 and subject to a $500 nonrecourse liability. Assume the $500 liability is a nonqualified liability.

5. The partnership agreement provides that partnership items will be allocated equally (50/50) between A and B, including excess nonrecourse deductions under Treas. Reg. § 1.752-3(a)(3).

6. B would be allocated 50 percent of the excess nonrecourse liability under the partnership agreement. Thus, immediately after the transfer, B's share of the liability equals $250, which is equal to B's 50 percent share of the excess nonrecourse liability of the partnership.

   a. By taking subject to the liability, the partnership is treated as having transferred $250 of consideration to B (the amount by which the liability exceeds B's share of the liability immediately after the transaction).

   b. B is treated as having sold $250 of the fair market value of the office building to the partnership in exchange for the partnership's taking subject to the $250 liability. This treatment results in a gain to B of $150, computed as the difference between the amount realized $250, less the portion of the adjusted basis allocable to that portion of the asset (($250/$1,000) multiplied by $400), or $100.

7. The Blue Book discussion relating to section 707(a)(2)(B) indicated that section 752 should apply to determine a partner's share of a liability for purposes of the disguised sale rule. Staff of J. Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 232 (Comm. Print 1984) (JCS-41-84). Nevertheless, the policy reasons underlying Treasury's decision not to determine a partner's share of a nonrecourse liability for purposes of the disguised sale rules strictly under the section 752 regulations are clear.

   a. Under the section 752 regulations, nonrecourse liabilities are allocated among the partners first to reflect each partner's share of partnership minimum gain, second to reflect each partner's share of "minimum" built-in gain under section 704(c), and third in proportion to the partners' respective interests in partnership profits. If the section 752 regime were used to determine a partner's share of nonrecourse liabilities for purposes of the disguised sale rules, nonsensical results would occur.

   b. Assume that B owns property with a $100 value and a $0 basis. B encumbers the property with a $100 nonrecourse loan and then contributes the encumbered property to a partnership in exchange for a 50% interest. Under the section 752 regulations, all $100 of the partnership nonrecourse liability is allocated to B to reflect the $100 of built-in gain allocable to B under section 704(c)(1)(A). Thus, if the section 752 rule applied for purposes of section 707(a)(2)(B), no portion of the nonrecourse liability would be treated as shifted away from B and therefore no portion of the liability would constitute a disguised sale payment. This would produce an inverse relationship between the gain inherent in the contributed

property and the extent of the disguised sale treatment. Preamble, T.D. 8439, 57 Fed. Reg. 44,974-01, 44,977 (Sept. 30, 1992).

c. Alternatively assume that the encumbered property contributed by B has a $100 value and an $80 basis. Under section 752, B's share of the liability would be $60 ($20 built-in gain under section 704(c) plus 50% of $80 excess). If this were also B's share of the liability for purposes of the disguised sale rules, B would be treated as selling to the partnership for $40 (the amount of the liability shifted) property with a basis of $32 (i.e., ($40/$100) x $80), resulting in an $8 gain. Thus, if section 752 were used to determine a partner's share of nonrecourse liabilities, a transfer of zero basis property subject to a nonrecourse liability would never result in disguised sale treatment, while a transfer of higher basis property subject to a nonrecourse liability would -- a nonsensical result.

8. Should a contribution of property subject to a nonrecourse liability <u>ever</u> be treated as a disguised sale? Arguably, when a partner contributes property subject to a nonrecourse liability, no shift of liability occurs; the liability is solely a burden on the property both before and after the transfer.

9. To avoid triggering the disguised sale rules, B might attempt to utilize a "wraparound contribution."

a. B borrows $500 secured by the building and contributes the encumbered building to GP. A and B agree that, as between themselves, GP neither assumes nor takes subject to the liability, rather B retains sole responsibility for payment of the debt.

b. To give B sufficient cash to service the debt, B receives a "reasonable" guaranteed payment or preferred return.

c. If GP is not treated as assuming or taking subject to the debt, the disguised sale rules regarding liabilities are not triggered. See Treas. Reg. § 1.707-5(a)(1); see also Stonecrest v. Commissioner, 24 T.C. 659 (1955) (holding that where a taxpayer sells property encumbered by a liability but the buyer and seller agree that, as between themselves, the seller shall have sole responsibility for payment of the liability, the liability is not "assumed or taken subject to" by the buyer under the installment sale rules).

10. Do the section 752 constructive contribution/distribution rules need to be coordinated with the property regulations? Assume that in exchange for a 50% partnership interest, A contributes property with a $0 basis and a $200 value, subject to a nonqualified recourse liability of $100.

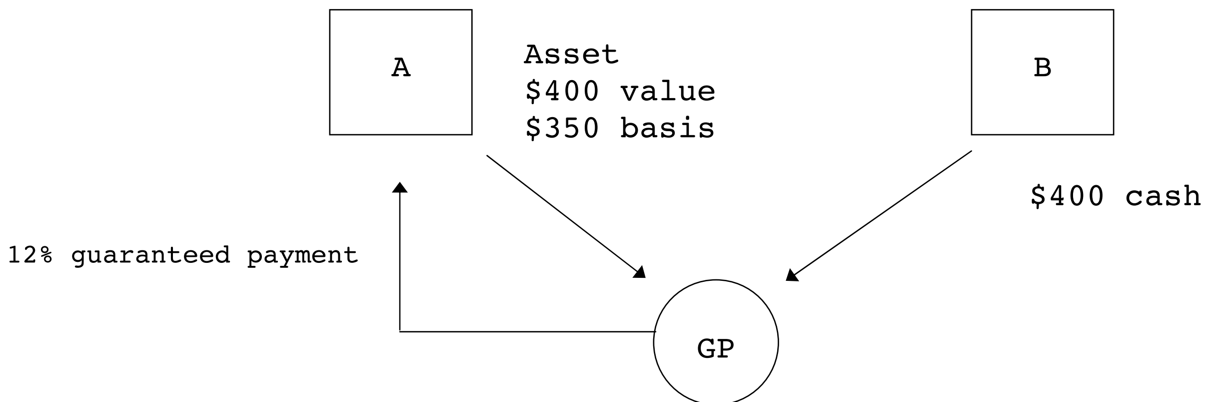
a. Under the section 752 regulations, A's share of the liability is $50. A is treated as being relieved of $100 of debt and as assuming $50 of the debt, resulting in a $50 constructive distribution to A. Sections 752(a), (b). A has a $50 gain ($50 constructive distribution less $0 basis in his partnership interest). Section 731(a).

b. Under the property regulations, A is treated as selling one-quarter of the property with a $0 basis, triggering $50 of gain.

c. Does A really have $100 of gain when A has only shifted away $50 of liability? Or are the section 752 rules applied after the deemed disguised sale? In such a

case, A should not receive a deemed distribution triggering gain pursuant to sections 752(b) and 731(a).

Partnership Disguised Sale Rules:
Guaranteed Payments, Preferred Returns,
and Operating Cash Flow Distributions



1. A contributes an asset to GP with a $400 value and $350 basis; B contributes $400 cash to GP.

2. A is entitled to receive a 12% guaranteed payment on the value of its asset. After the distribution of A's guaranteed payment, A and B share distributions of net cash flow and net sales proceeds 50/50.

3. Under the final regulations, the distributions to A described in paragraph 2 above likely will not be treated as part of a sale of A's asset to GP.

4. A guaranteed payment for capital (see section 707(c)) is not treated as part of a sale of property under the property regulations. A payment of money to a partner that is (i) characterized by the parties as a guaranteed payment for capital, (ii) determined without regard to the income of the partnership, and (iii) "reasonable" is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale. Treas. Reg. § 1.707-4(a)(1)(ii).

· A payment is "reasonable" if (1) the payment is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and (2) the payment is made for the use of capital after the date on which that provision is added to the partnership agreement. Treas. Reg. § 1.707-4(a)(3)(i). A payment is reasonable in amount if the sum of any guaranteed payment for capital (and preferred return) that is payable for that year does not exceed the amount determined by multiplying the partner's unreturned capital at the beginning of the year, or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid guaranteed payment or preferred return that is payable to the partner for any prior year) by the safe harbor interest rate for that year. The option of using the weighted average capital balance was added by the final property regulations. The safe harbor interest rate equals 150% of the highest applicable Federal rate in effect at any time from the time that the right to the guaranteed payment for capital is first established pursuant to a binding, written agreement. Treas. Reg. § 1.707-4(a)(3)(ii).

5. If A was to receive a preferred return instead of a guaranteed payment, distributions of the preferred return could also avoid disguised sale treatment. The property regulations define the term "preferred return" to mean a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain. A distribution of money to a partner that is characterized by the parties as a preferred return and that is "reasonable" is presumed not to be part of a sale of property to the partnership.

This presumption can only be rebutted by facts and circumstances (including the likelihood and expected timing of the matching allocation of income or gain to support the preferred return) that clearly establish that the transfer is part of a sale. Treas. Reg. § 1.707-4(a)(2).

a. Whether a preferred return is reasonable is determined in the same manner as is a guaranteed payment for capital; thus, the safe harbor rate of 150 percent of the applicable Federal rate applies. Treas. Reg. § 1.707-4(a)(3)(ii).

b. Presumably, if the partners agree to a reasonable preferred return that is not expected to be matched with allocations of income until the distant future, the payment of the preferred return may be treated as disguised sale proceeds.

6. A distribution of net operating cash flow is presumed not to be part of a sale of property contributed to the partnership. Transfers of money by a partnership to a partner during a taxable year will constitute operating cash flow distributions to the extent that (1) such distributions are not presumed to be guaranteed payments for capital, (2) such distributions are not reasonable preferred returns, (3) such distributions are not characterized by the parties as distributions to the recipient partner acting in a capacity other than as a partner, and (4) such distributions do not exceed the product of (a) the net cash flow of the partnership from operations for the year multiplied by (b) the lesser of the partner's percentage interest in "overall partnership profits" for that year and the partner's percentage interest in "overall partnership profits" for the life of the partnership. This presumption can only be rebutted by facts and circumstances that clearly establish that the distribution is part of a disguised sale transaction. Treas. Reg. § 1.707-4(b).

a. As a safe harbor, in lieu of determining a partner's interest in "overall partnership profits" for a taxable year, the property regulations permit the use of the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year. Treas. Reg. § 1.707-4(b)(2)(ii).

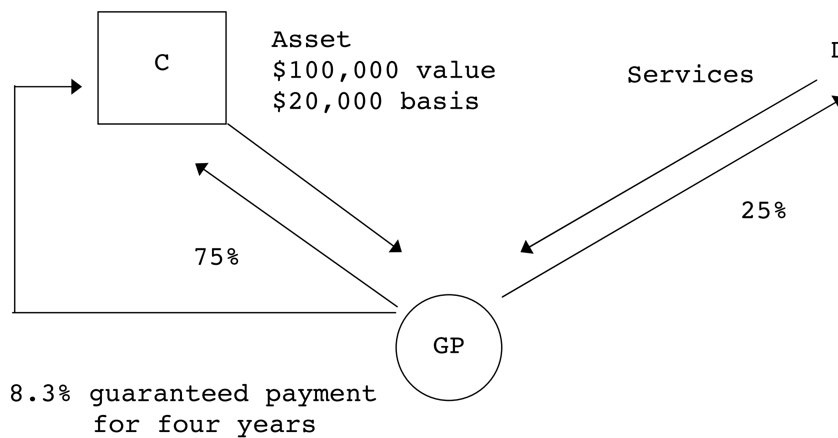
b. The property regulations define a partnership's net cash flow from operations in a manner that ignores partnership borrowings. This may represent an effort to "backstop" the special rules contained in Treas. Reg. § 1.707-5(b) regarding distributions of debt proceeds. Nevertheless, this omission may result in operating cash flow being computed in a manner that bears no relationship to reality. For example, if a partnership refinances a debt, the repayment of principal on the old debt reduces operating cash flow but the borrowing on the new debt does not increase it.

7. Assume A borrows funds using its partnership interest as collateral and services the debt from distributions of the guaranteed payment and net operating cash flow. If the guaranteed payment and operating cash flow distributions are presumed not to be part of a disguised sale, does A avoid disguised sale treatment?

8. In determining whether a preferred return or guaranteed payment is "reasonable", the computation of the return is based on a partner's unreturned capital at the <u>beginning</u> of the year, or, at the partner's option, based on the partner's weighted average of unreturned capital during the year. Because use of the weighted average capital balance is at the partner's option, the structuring of transactions can effect the amount of a "reasonable"

return. For example, if A elects to calculate his unreturned capital at the beginning of the year, A's distributions and contributions could be timed so as to provide A with a large amount of unreturned capital at the beginning of the year, permitting A a greater "reasonable" return.

Partnership Disguised Sale Rules:
Guaranteed Payments and Service Partner



1. The above diagram is based on Example 2 in Treas. Reg. § 1.707-4(a)(4). C contributes property with a $100,000 value and $20,000 basis to the partnership. D contributes no capital but manages the operations of the partnership.

2. C is to receive a guaranteed payment for capital of $8,333 per year for the first four years of the partnership's operations. Income and loss and distributions of net cash flow are to be allocated 75% to C and 25% to D, except that C's guaranteed payments are payable solely out of D's share of the net cash flow. If D's share of net cash flow is not sufficient to make C's guaranteed payments, D is obligated to contribute the shortfall to the partnership, even if the partnership is liquidated. In effect, the guaranteed payment to C will be funded entirely by D.

3. Because the guaranteed payment rate is within the safe harbor interest rate, Example 2 concludes that the payment is presumed to be a guaranteed payment. Nonetheless, for the following reasons, Example 2 concludes that the presumption is rebutted and sale treatment is appropriate.

a. The guaranteed payments place C and D in the same position as if D had purchased for $25,000 a one-quarter interest in the asset transferred to the partnership by C.

(i) Over the four years, C will have received $33,332 in guaranteed payments and have been allocated $25,000 of the deductions attributable to those payments. The allocations will reduce C's capital account by $25,000.

(ii) Additionally, a $25,000 loan requiring equal payments of principal and interest over a four-year term at a rate of 12% (compounded annually) would have required annual payments of principal and interest of $8,230.86.

b. The guaranteed payments place a burden on D's right to net cash flow distributions and D has an obligation to contribute additional capital to the partnership to make up any shortfalls.

4. Given that an 8.3% guaranteed payment for capital, payable to the only partner who made a capital contribution, is recharacterized as sales proceeds, Example 2 is alarming.

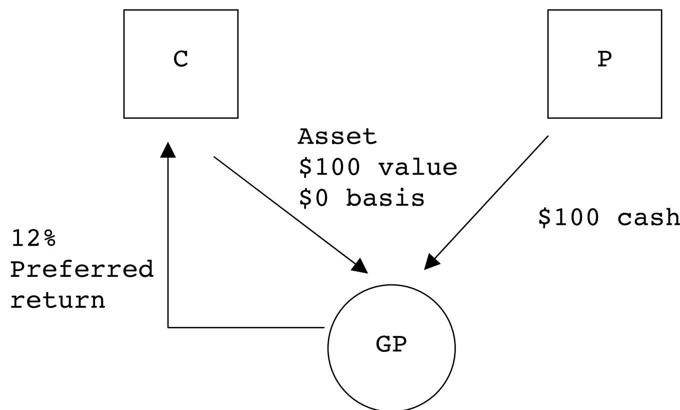
a. Example 2 makes much of the fact that the guaranteed payments were to be paid solely out of D's share of cash flow. Yet there is no special allocation of the deductions attributable to the guaranteed payments -- they are allocated 75/25 as are all other items. So long as liquidating distributions are made in accordance with capital accounts (as is assumed in Example 2), the guaranteed payments will be borne by both C and D 75/25.

b. Example 2 also makes much of the fact that D was required to make additional capital contributions to make up any shortfall. Yet there is nothing in Example 2 indicating that such contributions were ever made.

c. If C is viewed as selling property to the partnership in an installment sale and the property is depreciable, C generally would not be permitted to use installment reporting. Section 453(g).

5. For the treatment of D's receipt of a partnership profits interest in exchange for services, see Rev. Proc. 2001-43, 2001-2 C.B. 191; Rev. Proc. 93-27, 1993-2 C.B. 343. See also Prop. Treas. Reg. § 1.721-1(b); I.R.S. Notice 2005-43, 2005-1 C.B. 1221.

Partnership Disguised Sale Rules:
Preferred Return and Pledge of Partnership Interest



1. C contributes assets to the partnership with a $100 value and a $0 basis; P contributes $100 cash to the partnership.

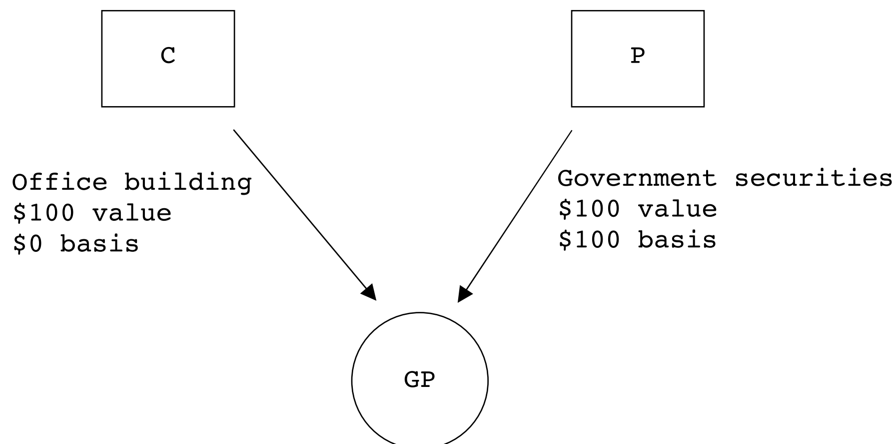
2. C is entitled to receive a 12% preferred return on the value of its assets. After the distribution of C's preferred return, distributions of net cash flow and net sales proceeds are made l% to C and 99% to P. The partnership agreement requires the partnership to be liquidated after 10 years. C pledges its partnership interest with a bank as security for a loan. The preferred return and anticipated liquidating distribution are sufficient to fund interest and principal payments on the loan.

3. Assume the applicable Federal rate is 8%. Under the property regulations under section 707(a)(2)(B), the various distributions to C described in paragraph 2 above likely will not be treated as part of a sale of C's assets to the partnership.

4. As discussed above, a preferred return on capital is not treated as part of a sale of property under the final regulations if it is "reasonable." If C were to receive a guaranteed payment for capital instead of a preferred return, distributions of the guaranteed payment could also avoid disguised sale treatment. See Treas. Reg. § 1.707-

4(a)(1). Further, a distribution of net operating cash flow is also presumed not to be part of a sale of property contributed to the partnership. See Partnership Disguised Sale Rules: Guaranteed Payments, Preferred Returns, and Operating Cash Flow Distributions, *supra*.

Partnership Disguised Sale Rules:
Use of Cross-Allocations Only



1. C contributes an office building to the partnership with a $100 value and $0 basis. The office building is substantially leased on a long-term basis.

2. P contributes government securities to the partnership with a $100 value and a $100 basis.

3. All items of income, gain, loss, and deduction from the government securities are allocated and net cash flow is distributed 99% to C and 1% to P. All such items from the office building are allocated 99% to P and 1% to C. The partners do not contemplate distributing any of the contributed assets or liquidating the partnership in the foreseeable future.

4. Because the partners do not contemplate distributing any of the contributed assets or liquidating the partnership in any relevant time frame, the circumstances are different from those in Example 8 in Treas. Reg. § 1.707-3(f), where a disguised sale was found.

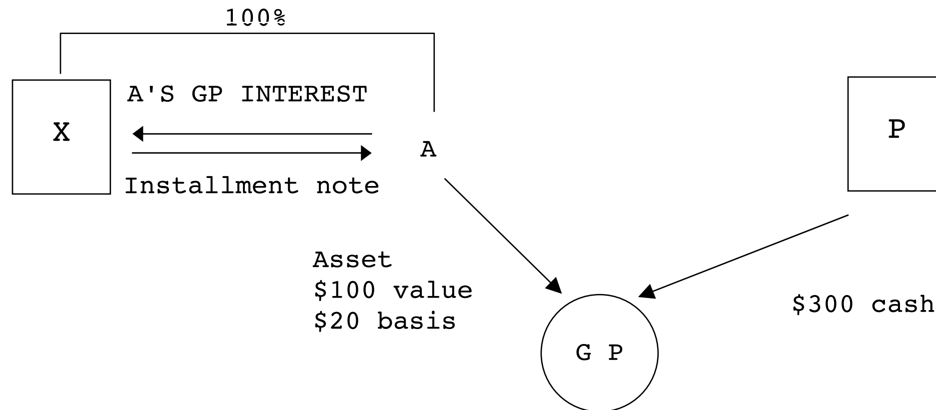
   - Additionally, the case of cross-allocations appears to be beyond the reach of the statutory rule authorizing the property regulations. Section 707(a)(2)(B)(ii)

requires a "transfer of money or other property by the partnership" to a partner in order for disguised sale treatment to apply. Where the only property received by the contributing partner within any relevant time frame is an interest in the partnership, section 721 provides for nonrecognition treatment and the statutory disguised sale rule should have no applicability.

5. As a general matter, a one percent interest in partnership income and loss is not so de minimis as to prevent a partner from being respected as such for Federal tax purposes. See, e.g., Rev. Proc. 89-12, 1989-1 C.B. 798, § 4.01 (in order to obtain an advance ruling that an entity is taxable as a partnership under the rules prior to the “check-a-box” regulations, the general partners taken together must have at least a one percent interest in all material items of partnership income and loss), obsoleted by, Rev. Rul. 2003-99, 2003-2 C.B. 388.

6. Query, however, the effect of the partnership anti-abuse rule of Treas. Reg. § 1.701-2?

Partnership Disguised Sale Rules:
Treatment of Transferees



1. Individual A contributes an asset with a $100 value and a $20 basis to the partnership in exchange for a 25% interest. P contributes $300 cash to the partnership in exchange for a 75% interest.

2. A sells its partnership interest to X, an S corporation wholly owned by A, for a $100 note. A reports the gain on the sale on the installment method.

3. The partnership then distributes $100 to X, which X uses to make other investments.

4. Because X made no contribution of property to the partnership, the distribution arguably should not be treated as part of a disguised sale. Under Treas. Reg. § 1.707-3(b)(1), in order for a disguised sale to occur, there must be "a transfer of property . . . by a partner to a partnership and a transfer of money or other consideration . . . by the partnership to the partner . . . ." (Emphasis added). But see section 707(a)(2)(B)(ii) (indicating that a disguised sale may occur if there is a transfer to the contributing partner or another partner).

5. In the Preamble to the property regulations, the Service noted the absence of anti-abuse rules for specific situations, such as related-party transactions, but concluded that general

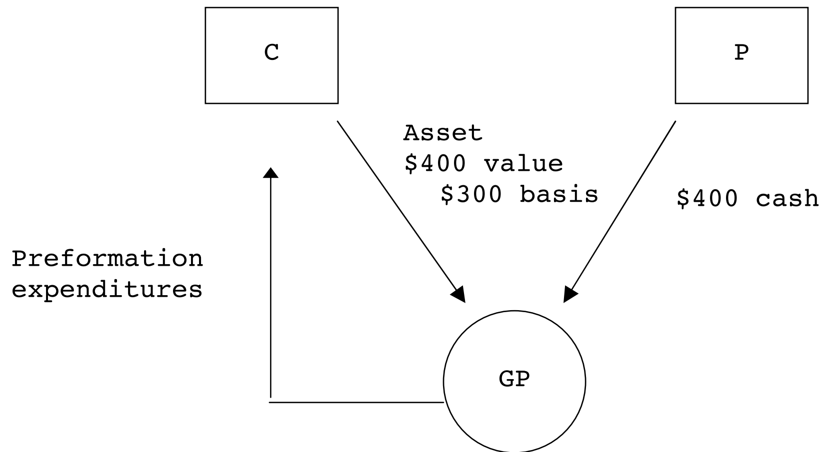
tax principles adequately addressed issues of abuse. Preamble, T.D. 8439, 57 Fed. Reg. 44,974-01, 44,975 (Sept. 30, 1992). The partnership anti-abuse rule of Treas. Reg. § 1.701-2 provides additional authority under which the Service could attack these transactions.

a. The Service may argue that the whole transaction should be treated as a sham or that X should "step into the shoes" of A and, therefore, be subject to disguised sale treatment.

b. Alternatively, the receipt of the $100 by X could be treated as a "second disposition" by X of property that was the subject of an installment sale, thereby triggering A's gain on the installment sale under section 453(e).

6. If the property A contributes to the partnership is depreciable or if the partnership otherwise owns depreciable property, section 453(g) may prevent A from reporting gain on the sale to X on the installment method. Section 453(g) generally prevents use of the installment method of reporting when depreciable property is sold to a related person in an installment sale. Although the partnership interest is not depreciable property, the Service may argue that it should be treated as such for purposes of section 453(g), particularly if the partnership has a section 754 election in effect so that the buyer obtains a step-up in the basis of depreciable partnership assets under section 743(b). See Rev. Rul. 72-172, 1972-1 C.B. 265 (portion of gain realized by husband and wife upon the sale of all the interests in a partnership to their wholly owned corporation ruled taxable as ordinary income under section 1239; transaction recharacterized as a sale of partnership assets (some of which were depreciable and therefore subject to section 1239) rather than of partnership interests).

Partnership Disguised Sale Rules:
Preformation Expenditures



1. C acquired property more than two years ago for $180 and spent $20 improving the property at that time.

2. C contributes to the partnership the property, which has a $400 value and $300 basis. Shortly before the contribution, C spent $100 to further improve the property. P contributes $400 cash to the partnership.

3. Consistent with Park Realty (discussed above), the property regulations provide that distributions made to reimburse partners for certain capital expenditures are not disguised sale proceeds. In order to qualify for reimbursement under this rule, the capital expenditure must have been incurred within two years before the property contribution to the partnership and must be (1) for partnership organization and syndication costs described in section 709 or (2) for property contributed to the partnership by the partner. Reimbursement for expenditures in this last category must not exceed 20% of the value of the contributed property at the time of the contribution. However, the 20 percent fair

market value limitation does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution. Treas. Reg. § 1.707-4(d).

a. If the partners want to distribute cash to C in accordance with the reimbursement safe harbor, the improvements made to the property more than two years ago may not be taken into account. With respect to the $100 of improvements made shortly before the contribution of the property to the partnership, must the 20% limitation be computed on the value of the improvements (20% of $100, or $20) or on the value of the entire property (20% of $400, or $80)?

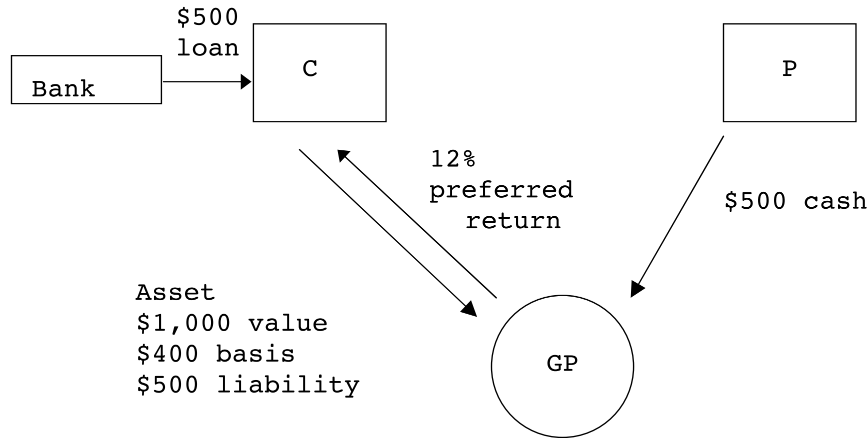
b. At most, the partnership could reimburse C for only $80 of the $120 C spent improving the property and fall within the reimbursement safe harbor.

4. Taxpayers have an incentive to debt-finance property that they expect may later be contributed to a partnership. A contribution of property encumbered by acquisition indebtedness is generally not subject to disguised sale treatment. Thus, a taxpayer may effectively obtain reimbursement for the entire cost of the encumbered property without regard to the 20% limitation or the two-year limitation in the reimbursement rule.

5. A parent corporation succeeds to the status of its subsidiary for purposes of the preformation expenditures exception under Treas. Reg. § 1.707-4(d) if the subsidiary liquidates into the parent in a section 381 transaction. In Rev. Rul. 2000-44, the Service held that when a corporation undertakes capital expenditures with respect to property which is acquired by its parent in a Section 381 transaction, the liquidation does not alter the circumstances under which the expenditures were originally incurred. As a result, if the parent contributes the property to a partnership, the parent may be reimbursed for the

expenditures without giving rise to a disguised sale as long as the expenditures meet the conditions of Treas. Reg. § 1.707-4(d). Rev. Rul. 2000-44, 2000-2 C.B. 336.

Partnership Disguised Sale Rules:
Wrap-Around Contribution



1. Under the property regulations, "qualified liabilities" assumed or taken subject to in connection with a transfer of property to a partnership generally are not treated as part of a sale. This rule applies to both recourse and nonrecourse liabilities.

2. Four categories of liabilities are "qualified liabilities." Treas. Reg. § 1.707-5(a)(6)(i). <u>See</u> Partnership Disguised Sale Rules: Contributions of Encumbered Property—Treatment of Qualified Liabilities, ¶4, *supra*.

3. In the case of a transfer of property in which the partnership assumes or takes subject to a liability other than a "qualified liability," the entire amount of the liability which is shifted to other partners is treated as an amount realized from a disguised sale, regardless of whether the partner receives any cash from the partnership.

4. To avoid triggering the disguised sale rules, a taxpayer might attempt to utilize a "wraparound contribution," as illustrated above.

   a. P contributes $500 cash to the partnership. C owns a building with a $1,000 value and a $400 basis. C borrows $500 secured by the building and contributes the

encumbered building to the partnership. C and P agree that, as between themselves, the partnership neither assumes nor takes subject to the liability. Rather, C retains sole responsibility for repayment of the debt.

b. To give C sufficient cash to service the debt, C receives a 12% preferred return on the value of the building. The 12% rate satisfies the "reasonable" return safe harbor.

c. If the partnership is not treated as assuming or taking subject to the debt, the disguised sale rules regarding liabilities are not triggered.

5. The above arrangement is analogous to the use of a "wraparound mortgage" under the installment sale rules. A number of cases have held that where a taxpayer sells property encumbered by a liability but the buyer and seller agree that as between themselves, the seller shall have sole responsibility for payment of the liability, the liability is not "assumed or taken subject to" by the buyer within the meaning of Treas. Reg. § 15A.453-1(b)(3)(i). See Stonecrest v. Commissioner, 24 T.C. 659 (1955); see also Republic Petroleum Corp. v. United States, 613 F.2d 518 (5th Cir. 1980); United Pac. Corp. v. Commissioner, 39 T.C. 721 (1963); Estate of Lamberth v. Commissioner, 31 T.C. 302 (1958).

- In 1981, the Service issued Temp. Treas. Reg. § 15A.453-1(b)(3)(ii) in an attempt to reverse the results in the Stonecrest line of cases. Temp. Treas. Reg. § 15A.453-1(b)(3)(ii) requires that a wraparound mortgage be treated the same as if the buyer had assumed or taken the property subject to the seller's mortgage, even though title does not pass and the seller remains liable on the mortgage.

However, the Tax Court invalidated this temporary regulation in Professional Equities, Inc. v. Commissioner, 89 T.C. 165 (1987).

6. Additionally, under Treas. Reg. § 1.707-5(a)(1), in order for the disguised sale rules regarding liabilities to apply there must be a contribution of property in which the partnership "assumes or takes subject to" a liability. A "wraparound contribution," if respected, should result in this prerequisite for application of the disguised sale rules regarding liabilities not being present. See also Jackson v. Commissioner, 708 F.2d 1402 (9th Cir. 1983) (no application of section 357(c) where transferor in section 351 exchange remained personally liable on debt and corporation did not assume debt on transferred property); Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989) (transferor in section 351 exchange allowed to set off personal liabilities owed to corporate transferee against liabilities assumed on the transfer for purposes of section 357(c)). But see Owen v. Commissioner, 881 F.2d 832 (9th Cir. 1989), cert. denied, 493 U.S. 1070, 110 S. Ct. 1113 (1990) (fact that shareholder remained liable on debt does not prevent application of section 357(c); rather, mere assumption or taking subject to debt is enough).

V. Case Law Applying Section 707(a)(2)(B) in Disguised Sale of Property Context

A. Virginia Historic Tax Credit Fund 2001, LP v. Commissioner, 639 F.3d 129 (4th Cir. 2011)

1. Facts

In 1996, Virginia enacted the Virginia Historic Rehabilitation Credit Program (“Virginia Program”) to provide state tax credits to individuals and businesses to encourage the preservation of historic buildings. The amount of credits granted for a rehabilitation project depended on the amount of eligible expenses incurred. The Virginia Program included a

partnership allocation provision that allowed owners to use their excess credits to attract capital contributions. This allocation provision permitted state tax credits granted to a partnership to be allocated among all partners either in proportion to their ownership interest or as the partners agreed. Consequently, owners frequently engaged in partnership arrangements that allocated a disproportionate share of the state tax credits to investor partners in order to attract capital investment. The partnerships and LLC at issue (collectively, the partnerships) were formed to provide funding for small historic rehabilitation projects. The partnerships acquired interests in other partnerships or LLCs that were involved in the rehabilitation of property and, thus, entitled to state tax credits. The partnerships pooled capital from investors to support these rehabilitation projects, resulting in the allocation of state tax credits to the partnerships. Investors who contributed capital to the partnerships received a partnership or LLC interest and were allocated a share of credits from the pool of credits generated by the partnerships.

2. Relevant Arguments

The Commissioner primarily contended that the investors were not partners for Federal tax purposes and that, consequently, the investors' capital contributions to the partnerships and receipt of the state tax credits should be treated as sales of the credits. As an alternative argument, the Commissioner contended that the investors' capital contributions to the partnerships coupled with the allocations of state tax credits were disguised sales under section 707(a)(2)(B) between the partnerships and their respective partners.

3. Tax Court Ruling

The Tax Court concluded that the investors were partners in the partnerships for Federal tax purposes. The court then held that the transactions should not be treated as disguised sales under section 707(a)(2)(B). In its disguised sale analysis, the court found that the substance of the transactions reflected valid contributions and allocations rather than sales. The court

stated that the investors made capital contributions to the partnerships in furtherance of their purpose to invest in developer partnerships involved in historic rehabilitations and to receive state tax credits. The court found that, because of the investors' pooled capital, the partnerships were able to participate in the developer partnerships. The court also noted that the partnerships' allocation of the resulting pooled credits to the investors as agreed in the partnership agreements was consistent with the allocation provisions of the Virginia Program.

In holding that the transactions should not be recharacterized as disguised sales, the court also relied in part on the fact that the transfers were not simultaneous. The court pointed out that the investors contributed capital at various times during the years at issue, while the state tax credits were allocated to the partners when the partnerships attached the certificates to their respective Forms 1065 (Schedule K-1). The court also noted that the subsequent transfer of the state tax credits was subject to the entrepreneurial risks of the partnerships' operations. Although the investors were promised certain amounts of credits in subscription agreements, the court found that there was no guarantee that the partnerships would pool sufficient credits.

Finally, the court stated that it was not determining whether state tax credits constituted property that could be sold for tax purposes. The court merely assumed this position for purposes of its analysis.

4. Fourth Circuit Ruling

On appeal, the Court of Appeals for the Fourth Circuit reversed the decision of the Tax Court. The Fourth Circuit's holding was based on the determination that the transaction represented a disguised sale of state tax credits under section 707(a)(2)(B). To reach this conclusion, the court first determined that the allocation of state tax credits constituted a transfer of "property" under section 707. The partnerships contended that the transactions did not involve an exchange of money for property, noting that the tax credits were nontransferable

under Virginia law. The court found that the tax credits were "valuable" and imbued with "some of the most essential property rights." On the issue of transferability, the court characterized Virginia's law prohibiting the tax credits from being bought and sold directly as a nominal prohibition, as a third-party transfer could be effectuated through the formation of a partnership and an allocation of the credits.

While the court spent substantial time on whether the tax credits constituted "property" under section 707, it seemed unconcerned with the fact that section 707(a)(2)(B) also requires a "transfer" of property rather than a "transfer or allocation" of property. The court seemed to be equating an "allocation" of credits with a "transfer" of credits. Note that Congress uses both "transfer" and "allocate" in section 707(a) for various purposes. So, it is curious that the court seemed to conclude that "transfer" in section 707(a)(2)(B) implicitly includes "allocate."

The court then started with the presumption that the transaction was a sale under Treas. Reg. § 1.707-3(c) because the transfers occurred within 2 years of each other. The court found that the partnerships could not overcome this presumption, as the majority of the factors provided in Treas. Reg. § 1.707-3(b)(2) weighed in favor of disguised sale treatment. The court reached this conclusion based on the following findings: (i) the timing and the amount of the subsequent transfer was determinable with reasonable certainty at the time of the earlier transfer – the partnerships promised a precise number of tax credits, which were to be delivered for use in the investor's tax calculations for 2001; (ii) the investors had a legally enforceable right to the later transfer of the tax credits – the investors were promised delivery of tax credits, and could have pursued a breach of contract action if the partnerships acquired credits and refused to allocate them to the investors; (iii) the investors' contributions were secured in several ways, as the investors were to be refunded if sufficient credits could not be obtained, and the partnerships

were only to invest the investors' capital with developers after state approval requirements for the rehabilitation credit were received; (iv) the tax credits allocated to the investors by the partnerships were disproportionately large in relation to the investors' continuing interest in partnership profits – the investors had effectively no interest in partnership profits, and the allocation of the tax credits to the investors had no correlation to the investors' partnership profits interests, which were tied to the amount of money contributed by each investor; and (v) after receiving the allocation of the tax credits, the investors had no further obligations or relationship with the partnerships. An additional factor noted by the court as supporting the finding of a disguised sale (which is not listed in Treas. Reg. § 1.707-3(b)(2)) was that the partner status of the investors was transitory in nature.

The Fourth Circuit rejected the Tax Court's finding that the investors, after giving their money to the partnerships but before receiving an allocation of tax credits, faced entrepreneurial risks from the partnerships' operations. The court characterized these risks as "speculative and circumscribed" and concluded that there was no true entrepreneurial risk faced by the investors. According to the court: (i) the investors were effectively promised a fixed rate of return; (ii) the investors received a nominal partnership interest and no material allocation of income, gain, or loss; (iii) the investors were secured against losing their contributions by the promise of a refund if tax credits could not be allocated; and (iv) to hedge against insolvency, investor contributions were given to developers only after state approval requirements for the tax credits were received (i.e., when the projects were completed). Accordingly, the court concluded that the partnerships should have included the money received from the investors as income in their tax returns.

B. Canal Corp. v. Commissioner, 135 T.C. 199 (2010)

1. Facts

W, a wholly-owned subsidiary of C, and GP, an unrelated corporation, proposed to transfer the assets of their respective tissue businesses into newly-formed GP Tissue, LLC (the "LLC"), which was treated as a partnership for Federal tax purposes. In 1999, GP transferred assets valued at $376.4 million to the LLC in exchange for a 95-percent LLC interest, and W contributed $775 million in assets to the LLC in exchange for a 5-percent LLC interest. On the same day it received the contributions from W and GP, the LLC borrowed $755.2 million from Bank of America and immediately transferred the loan proceeds to W as a special cash distribution. GP guaranteed payment of the Bank of America loan, and W agreed to indemnify GP for any principal payments made pursuant to GP's guaranty. W used a portion of the funds from the special distribution to repay an intercompany loan to another subsidiary of C. W also used portions of the funds to pay a dividend to C, repay amounts owed to C, and lend $151 million to C in exchange for a note. W's only assets after the transaction were its LLC interest, the note from C, and a corporate jet. The LLC thereafter borrowed funds from a financial subsidiary of GP to retire the bank loan. GP executed a substantially identical guaranty in favor of the new lender, and W executed a substantially identical indemnity obligation.

In 2001, GP entered into a separate transaction that required it to divest its entire interest in the LLC. W subsequently sold its LLC interest to GP for $41 million, and GP then sold all the interests in the LLC to an unrelated party. C reported a $524 million capital gain from the sale on its consolidated income tax return for 2001, due mainly to a deemed distribution of cash to W pursuant to section 752 arising from the sale. GP also paid C $196 million to compensate C for the loss of tax deferral that GP initially assured W it would receive, which C reported as ordinary income on its 2001 consolidated income tax return. The Service determined that the leveraged mixing-bowl transaction was a disguised sale by W of its tissue business that resulted in capital gain includible in C's consolidated income for 1999 (rather than 2001).

2. Relevant Arguments

The taxpayer asserted that the LLC's special distribution of cash to W was not part of a disguised sale, but was a tax-free debt-financed distribution to a partner. The regulations except certain debt-financed distributions in determining whether a partner received money or other consideration for disguised sale purposes. See Treas. Reg. § 1.707-5. A distribution financed from the proceeds of a partnership liability may be taken into account for disguised sale purposes to the extent the distribution exceeds the distributee partner's allocable share of the partnership liability.

The taxpayer also asserted that the transaction should not be recast as a sale because the anti-abuse rule under Treas. Reg. § 1.752-2(j) did not disregard W's agreement to indemnify GP, which, according to the taxpayer, imposed on W the economic risk of loss for the relevant LLC debt. Under the anti-abuse rule, a partner's obligation to make a payment may be disregarded if (i) the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's risk of loss or to create a facade of the partner's bearing the economic risk of loss with respect to the obligation, or (2) the facts and circumstances of the transaction evidence a plan to circumvent or avoid the obligation. See Treas. Reg. § 1.752-2(j)(1), (3).

The Service argued that the taxpayer structured the transaction to defer capital gain, contending that W did not bear any economic risk of loss when it entered the joint venture agreement because the anti-abuse rule under Treas. Reg. § 1.752-2(j) operated to disregard W's obligation to indemnify GP. Thus, according to the IRS, the transaction should be treated as a disguised sale (rather than a tax-free contribution of business assets followed by a tax-free distribution of cash).

3. Ruling

The Tax Court found that the facts and circumstances evidenced a disguised sale, and held that W sold its business assets to GP in 1999, the year it contributed the assets to the LLC (rather than the year it sold its LLC interest). Under Treas. Reg. § 1.707-3(c)(1), W's transfer of assets to the LLC and simultaneous cash distribution were presumed to effect a sale unless the facts and circumstances clearly established otherwise.

Addressing the taxpayer's argument that the distribution was not part of a disguised sale because it was a debt-financed distribution, the court examined whether W had any allocable share of the LLC's liability that financed the distribution. To make this determination, the court (in accordance with the liability-sharing rules under section 752) focused on whether W bore any economic risk of loss under its agreement to indemnify GP. The court found that the taxpayer crafted the indemnity agreement to limit any potential liability to W's assets. The court focused on the following findings. GP did not require the indemnity, and the indemnity agreement did not obligate W to maintain a certain net worth. C, W's parent, was well capitalized, while W's net worth amounted to approximately 21 percent of the indemnified LLC liability. W was chosen as the indemnitor because it would cause the economic risk of loss to be borne only by W's more limited assets rather than C's more expansive assets. The relevant contractual provisions also reduced the likelihood of GP invoking the indemnity against W. The court further noted that, regardless of how remote the possibility was that W would have to pay anything under the indemnity agreement, W lacked sufficient assets for it to respect the indemnity. In particular, the court noted that C could remove W's main asset, the intercompany note, from W's books at any time. The court determined that W's agreement to indemnify GP's guaranty lacked economic substance and afforded no real protection to GP.

Accordingly, the court concluded that the indemnity agreement should be disregarded because it created no more than a remote possibility that W would actually be liable

for payment. The court found that W had no economic risk of loss and should not be allocated any part of the debt incurred by the LLC. Consequently, the court determined that the distribution of cash to W did not fit within the debt-financed distribution exception to the disguised sale rules.

C. United States v. G-I Holdings, Inc., 2010-1 U.S.T.C. ¶ 50,332 (D. N.J. 2009)

1. Facts

In 1990, G-I Holdings Inc. and ACI Inc. (collectively, "GAF") and Rhone-Poulenc S.A. ("RP") entered into a partnership agreement forming Rhone-Poulenc Surfactants and Specialties, LP ("RPSSLP"). GAF transferred the assets of its surfactants chemicals business, valued at $480 million, to RPSSLP as a contribution to the partnership. In exchange, GAF received a limited partnership interest representing a 49-percent interest in RPSSLP. RP transferred approximately $480 million in assets to RPSSLP in exchange for a 49-percent limited partnership interest and created a holding company, Rhone-Poulenc Specialty Chemicals, Inc ("RPSC"), to act as the general partner in RPSSLP. GAF assigned its limited partnership interest in RPSSLP to CHC Capital Trust ("CHC Trust"), which pledged the partnership interest as collateral for a loan of approximately $460 million, the proceeds of which were required by the CHC Trust agreement to be distributed to GAF. GAF subsequently received approximately $450 million of the loan proceeds. GAF's asset contribution to RPSSLP and the distribution of the loan proceeds to GAF took place on the same date. The loan was nonrecourse and was secured only by GAF's partnership interest in RPSSLP. The loan required monthly interest payments, which were funded through an agreement between GAF and RPSSLP that entitled GAF to a monthly priority return distribution. The priority return distributions were distributed to CHC Trust and used to pay any interest due on the loan, with any surplus proceeds distributed to GAF.

Under the partnership agreement, RPSC was required to cause RPSSLP to pay the priority return distribution each month regardless of RPSSLP's profit or loss. The financial obligations of RPSC under the partnership agreement were guaranteed by RP. Further, the transactions were structured with protections that assured that GAF would have the necessary money to repay the loan.

2. Relevant Arguments

GAF argued that the contribution of assets to RPSSLP was a non-taxable contribution to a partnership under section 721(a). GAF made various arguments that the form of its contribution to RPSSLP should be respected, and that the entire $480 million in assets represented a valid equity contribution. The government contended that GAF's purported contribution transaction was a taxable disposition of the transferred assets because (i) the transaction constituted a disguised sale under section 707(a)(2)(B), or, alternatively, (ii) RPSSLP was not a valid partnership for tax purposes or, if RPSSLP was a valid partnership, neither G-I Holdings nor ACI were partners in the partnership.

3. Ruling

The district court held that $450 million of GAF's asset contribution to RPSSLP should be recharacterized as a sale of property. The court concluded that RPSSLP was a valid partnership for Federal tax purposes, but that only $30 million of GAF's asset transfer represented a valid, non-taxable contribution to the partnership under section 721(a) (the excess of GAF's $480 million investment in the partnership over the $450 million received by GAF from the loan). According to the court, the remaining $450 million in assets purportedly contributed by GAF to RPSSLP was more properly characterized as a sale of property. The court relied on four considerations in reaching its conclusion: (1) the risk of loss, (2) the potential profits, (3) the historical context in which the transactions occurred, and (4) the

disguised sale analysis of the transactions. The court found that GAF had no risk of loss on the transfer of the $450 million in assets to RPSSLP, and noted that the parties had stipulated that GAF's potential loss was capped at $26.3 million. The court also determined that GAF did not enter into the partnership arrangement with the intent of making a profit. The court disregarded any assertion of a profit-motive by GAF as not credible, pointing out that GAF's transaction costs exceeded its expected gain from the partnership. Furthermore, the court determined that the historical circumstances surrounding the transactions demonstrated that GAF did not intend to enter into a joint venture with RP. GAF and RP had previously decided to structure the transaction as an asset sale, which the court found suggested that GAF selected the RPSSLP partnership structure solely as a means to sell its assets in a manner that minimized taxation.

Lastly, the court concluded that the $450 million in assets transferred by GAF to RPSSLP was properly characterized as a sale pursuant to section 707(a)(2)(B). The court noted that this determination received the greatest weight in its assessment of the substance of GAF's transaction. The court found that each of the statutory elements listed in section 707(a)(2)(B) were present. The court held that GAF's transfer of $450 million in assets to RPSSLP was a direct transfer of money or other property by a partner to a partnership under section 707(a)(2)(B)(i). The court also held that the $450 million in loan proceeds received by GAF constituted an indirect transfer of money or other property by the partnership to a partner under section 707(a)(2)(B)(ii). The court found that, in substance, the loan was structured to function as a payment to GAF, as GAF was not liable for the loan and repayment rested indirectly with RPSSLP, RPSC, or RP. The court then held that GAF's asset contribution and loan transaction, when viewed together, was properly characterized as a sale of property under section 707(a)(2)(B)(iii). In reaching this conclusion, the court noted that the application of the section 707(a)(2)(B) disguised sale statute was a matter of first impression and turned to the statute's

legislative history for guidance in interpreting the meaning of this statutory language. The court cited six factors from the Senate Finance Committee's explanation of section 707(a)(2)(B) for determining whether a disguised sale exists, of which four were identified by the court as applicable to the instant case: (1) whether the payment received by the partner is subject to an appreciable risk as to amount, (2) whether the partner status of the recipient is transitory, (3) whether the distribution made to the partner is close in time to the partner's transfer of property to the partnership, and (4) whether, under all the facts and circumstances, it appears the taxpayer became a partner primarily to obtain tax benefits that would not have otherwise been available. The court held that none of the four factors weighed in favor of finding that the $450 million of GAF's asset transfer was a valid contribution to RPSSLP, as the $450 million received by GAF through the loan was subject to no risk, the contribution and loan transactions took place on the same day, and GAF's primary motivation for participating in the transaction was to receive tax benefits (the court noted that GAF's continued partner status did not weigh in either direction). The court also looked to the relevant Treasury regulations issued under section 707(a)(2)(B) for guidance on the factors to be considered in deciding whether GAF's transaction was properly recharacterized as a sale. The court recognized that the regulations were promulgated after the transaction at issue and were, thus, non-binding but, nevertheless, viewed the regulations as informative. The court examined each of the ten factors listed in Treas. Reg. § 1.707-3(b)(2) and summarily concluded that the relevant factors weighed in favor of finding that the transactions should be characterized as a sale.

After examining the legislative history of section 707(a)(2)(B) and the relevant Treasury regulations, the court then conducted its own analysis of GAF's $450 million contribution transaction, listing seven factors that, according to the court, received the greatest weight in its determination that the transaction should be recharacterized as a sale: (1) the

historical context suggested a sale was intended, (2) the contribution and loan transactions were carefully planned and structured together, (3) GAF restructured the asset sale with the principal objective of reducing taxation in an exchange of assets for cash, (4) the contribution and loan transactions were integrated and interlocking, (5) the contribution and loan transactions closed on the same date, (6) in making the contribution, GAF ceded operational control of its assets, and (7) the transactions were structured so that the loan functioned as a payment in substance.

Despite the finding that GAF's transaction constituted a disguised sale, GAF ultimately prevailed because the government's asserted deficiency was time-barred. The court held that the government was unable to establish that it was entitled to the six-year statute of limitations for assessments provided in section 6501(e)(1)(A) for substantial omissions from gross income. Accordingly, the court's discussion of the disguised sale issue could be viewed as mere dicta.

VI. Administrative Guidance on Disguised Sales of Partnership Interests

No case has addressed the application of section 707(a)(2)(B) in the context of a disguised sale of a partnership interest. Prior to the issuance of the now-withdrawn proposed interest regulations (discussed below), the Service, in a handful of administrative pronouncements, had applied section 707(a)(2)(B) to find disguised sales of partnership interests. See TAM 200301004; TAM 200037005; CCA 200250013; CCA 200224007; FSA 200024001. Due to the decision by Treasury and the Service to withdraw the proposed interest regulations, the non-regulatory administrative guidance issued prior to the issuance of the proposed interest regulations has renewed significance in any disguised sale inquiry.

The Service has determined that, in applying section 707(a)(2)(B) in the absence of final Treasury regulations regarding disguised sales of partnership interests, taxpayers should use the statutory language of section 707(a)(2)(B) and the guidance in the legislative history.

See I.R.S. Notice 2001-64, 2001-64 C.B. 316 (providing that the statute and the guidance in the legislative history should be applied in the absence of final Treasury regulations); TAM 200301004 (same); TAM 200037005 (same); CCA 200250013 (same); see also Treas. Reg. § 1.707-9(a)(2) (providing that taxpayers should apply the statute and the guidance in the legislative history to transactions (including transactions involving the disguised sale of a partnership interest) that occur before the effective date of the current regulations under section 707(a)(2)(B)).

Note that section 707(a)(2)(B) does not provide any substantive rules itself. Instead, it calls for the substantive disguised sale rules to be issued "under regulations prescribed by the Secretary." Accordingly, taxpayers have taken the position that the Service cannot challenge disguised sales of partnership interests under section 707(a)(2)(B) until final Treasury regulations are issued. The Service has taken the position that the statutory directive for Treasury regulations in section 707(a)(2)(B) is self-enforcing. See TAM 200301004; TAM 200037005; CCA 200250013.

Case law that addresses whether a statutory directive for regulations is self-enforcing seems to focus on whether the relevant statutory directive is a policy directive (i.e., a directive that permits Treasury to decide whether to apply a provision) or a non-policy directive (i.e., a directive that permits Treasury only to determine how a provision will apply but with no discretion to determine whether the provision should apply in the first place). See Estate of Neumann v. Commissioner, 106. T.C. 216 (1996). If the statutory directive is interpreted to be a policy directive, then the statutory directive should not be self-enforcing. See, e.g., Alexander v. Commissioner, 95 T.C. 467 (1996) (interpreting a statutory directive that read "only to the extent provided in regulations" as not being self-enforcing). If the statutory directive is interpreted to

be a non-policy directive, then the statutory directive should be self-enforcing. See, e.g., Pittway Corp. v. United States, 102 F.3d 932 (7th Cir. 1996) (interpreting a statutory directive exactly like the statutory directive in section 707(a)(2)(B) as being self-enforcing). Most of the case law dealing with this issue has found statutory directives for regulations to be self-enforcing. See generally Phillip Gall, Phantom Tax Regulations: The Curse of Spurned Delegations, 56 The Tax Lawyer 413 (Winter 2003).

A. Administrative Guidance Prior to Issuance of Proposed Interest Regulations

1. I.R.S. Notice 2001-64, 2001-64 C.B. 316

In Notice 2001-64, the Service requested comments on the scope and substance of proposed Treasury regulations under section 707(a)(2)(B) concerning disguised sales of partnership interests. "Prior to the issuance of regulations, the determination of whether a transaction is a disguised sale of a partnership interest under § 707(a)(2)(B) is to be made on the basis of the statute and its legislative history." I.R.S. Notice 2001-64.

2. Relevant IRS Written Determinations

Even prior to the issuance of the proposed interest regulations, the Service had attempted to recharacterize transactions as disguised sales of partnership interests on several occasions. The administrative guidance evidences an intent generally by the Service to apply a three-pronged analysis to the issue of a disguised sale of a partnership interest. First, there must be a direct or indirect transfer of money or other property by a partner to a partnership. Second, it must be shown that there is a related direct or indirect transfer of money or other property by the partnership to such partner or another partner. Third, the transfers described in the previous

two prongs, when viewed together, must be properly characterized as a sale (i.e., to satisfy the third prong, it must be shown that the related transfers to and from the partnership were in substance a sale or exchange of a partnership interest between partners).

a) TAM 200301004 (Aug. 27, 2002) (disguised sale of partnership interest)

(1) Facts

TP and X considered the formation of a new business, but X decided not to invest in the business until a future time, if at all. So, TP's three affiliates formed a general partnership to conduct the business initially. TP, X, and X's affiliate, Y, also entered into an option agreement that permitted Y to enter the new business in the future under one of three alternative ways. The three alternatives all involved a contribution to the partnership by Y of an amount intended to equalize the investments of TP and Y (i.e., the investment amount). The first alternative required Y to contribute the full investment amount to the partnership and then required the partnership to distribute a certain portion of that contributed amount to TP and Y. The second alternative required Y to contribute a portion of the full investment amount to the partnership and then required the partnership to distribute a portion of the contributed amount to TP only. The third alternative required Y to purchase a portion of TP's partnership interest (through TP's affiliates). Y elected to exercise the option, and TP chose the second alternative. Thus, Y contributed a portion of the investment amount to the partnership, and the partnership distributed a portion of that contributed amount to TP on or about the same time as the contribution.

(2) Issue and Conclusion

Whether the transactions are properly characterized as a disguised sale of a partnership interest from TP to Y? Yes.

(3) Ruling

The National Office of the Service (the "National Office") reviewed section 707(a)(2)(B) and its legislative history. It noted that Congress provided in the legislative history that it was concerned about court decisions, such as CSC and Jupiter, that allowed tax-free treatment in cases which were economically indistinguishable from sales of property to a partnership or another partner. It also noted that the legislative history specifically mentioned that disguised sales of partnership interests were not found to exist in CSC and Jupiter despite current regulations under sections 721 and 731 (i.e., Treas. Reg. §§ 1.721-1(a) and 1.731-1(c)(3)) that should have permitted such findings, and, thus, section 707(a)(2)(B) was enacted to expressly prohibit such transactions. The National Office then introduced a three-pronged approach to applying section 707(a)(2)(B): "Section 707(a)(2)(B) lists three elements that must be satisfied to recharacterize property transfers to and from a partnership as a transaction between two or more partners acting other than in their capacity as members of the partnership. First, there must be a direct or indirect transfer of money or other property by a partner to a partnership. . . . Second, it must be shown that there is a related direct or indirect transfer of money or other property by the partnership to such partner. . . .Third, the transfers described in the previous [prongs], when viewed together, must be properly characterized as a sale. Therefore, to satisfy the third requirement of §707(a)(2)(B) it must be shown that the related transfers to and from [the partnership] were in substance a sale or exchange of . . . partnership interests between [partners]." The National Office found that the first prong was satisfied since

Y transferred cash to the partnership. The National Office found that the second prong was satisfied, because the option agreement required Y to transfer the cash to the partnership, and it also required the partnership to transfer some of that cash to TP, which in fact occurred. The National Office seemed to apply a "but for" test to determine whether the transfers were related. It stated, "The transfer by [the partnership] to TP, would not have occurred but for the transfer from Y to [the partnership]. Accordingly, the first and second elements enumerated in § 707(a)(2)(B) are satisfied in this case." The National Office found that the third prong of the test was satisfied because the contribution and distribution caused a permanent equity shift of the partnership's capital from TP to Y. The National Office also found significant that the facts were similar to the facts in CSC, which was a case with which Congress signaled its disagreement in the legislative history of section 707(a)(2)(B). Finally, the National Office found that it could enforce section 707(a)(2)(B) in the context of a disguised sale of a partnership interest despite the absence of regulations. The National Office cited Notice 2001-64 and several redacted authorities dealing with self-executing regulations to conclude that, prior to the issuance of regulations, the determination of whether a transaction is a disguised sale of a partnership interest under section 707(a)(2)(B) is to be made on the basis of the statute and its legislative history.

b) TAM 200037005 (May 18, 2000) (disguised sale of partnership interest)

(1) Facts

At the end of a complex set of steps, the following circumstances existed. Several partners (the "Original Partners") owned interests in two partnerships, P1 and P2. P2 also owned

an interest in P1. A real estate investment trust ("REIT") owned an interest in another partnership, P3. All pursuant to the same plan, P1 distributed partner note receivables ("Partner Loan Receivables") to P2. (The Partner Loan Receivables related to loans made by P1 to the Original Partners in an earlier step of the transaction. Thus, coupled with the fact that P2 was wholly-owned (directly and indirectly) by the Original Partners, the distribution of the Partner Loan Receivables to P2 amounted to a cancellation of those debts for the Original Partners.) Around the same time as the distribution from P1 of the Partner Loan Receivables, REIT contributed to P1 its interest in a different note receivable ("TR Loan Receivable"), an option ("TR Option"), and cash in exchange for a general partner interest in P1. P3 also made a contribution to P1 of its interest in the TR Loan Receivable in exchange for a general partner interest in P1. (The TR Loan Receivable represented a loan that several third party lenders had made to P1 in an earlier step of the transaction. Thus, the contribution of the TR Loan Receivable amounted to a cancellation of that debt for P1.)

(2) Issue and Conclusion

Whether the transactions effectuated a disguised sale of interests in P1 from the Original Partners to REIT and P3? Yes.

(3) Ruling

The National Office began by reviewing section 707(a)(2)(B) and its legislative history just as it did in TAM 200301004. The National Office then concluded that P2 should be disregarded for lack of economic substance. As a result, the distribution of the Partner Loan Receivables to P2 was treated as a distribution of the Partner Loan Receivables directly to the

Original Partners, resulting in a cancellation of those debts for the Original Partners. Afterward, the National Office introduced its analysis of the disguised sale issue by stating: "The substance of the [transactions] is similar to the substance of the transactions in Jupiter and Communications Satellite, cases cited by Congress as part of the reason for enacting section 707(a)(2)(B) to prohibit disguised sales of partnership interests." The National Office introduced the same three-pronged approach to analyzing section 707(a)(2)(B) as described in TAM 200301004. The National Office found that the contributions to P1 by REIT and P3 satisfied the first prong of the analysis. It also found that the distribution by P1 to P2 of the Partner Loan Receivables satisfied the second prong of the analysis. The National Office also found that the following facts satisfied the third prong of the analysis. First, prior to the transactions, REIT and P3 held no interests in P1, and, as a result of the transactions, the interests of REIT and P3 in P1 increased and the interests of the Original Partners in P1 decreased. Second, the contribution of the TR Loan Receivable to P1 (i.e., a relief of liability for P1) and the distribution of the Partner Loan Receivables by P1 (i.e., the elimination of an asset of P1) did not change the amount of capital in P1. Third, the economic substance of the transactions was equivalent to the following: (i) REIT and P3 transferring cash to the Original Partners in exchange for their interests in P1, (ii) the Original Partners then using that cash to pay off the Partner Loan Receivables to P1, and (iii) P1 then using that cash to pay off the TR Loan Receivable to P3 and REIT. Finally, just like in TAM 200301004, the National Office concluded that it could enforce section 707(a)(2)(B) in the context of a disguised sale of a partnership interest despite the absence of regulations. The National Office cited Pittway Corp. v. United States, 102 F.3d 932 (7th Cir. 1996), which found an excise tax statute self-enforcing when it used the same words as section 707(a)(2)(B) – "Under regulations prescribed by the Secretary," Estate of Neumann v. Commissioner, 106 T.C.

216 (1996), which found a generation-skipping tax statute self-enforcing, because the statute gave the Treasury the power to address how the tax should be applied rather than whether the tax should apply at all, and Rev. Rul. 91-47, 1991-2 C.B. 16, where the Service enforced section 108(e)(4) prior to the issuance of regulations despite the statute applying "to the extent provided in regulations."

c) CCA 200250013 (Aug. 30, 2002) (disguised sale of property and disguised sale of partnership interest)

(1) Facts

Corporations, W and X, owned 50 percent interests in a partnership. W and X wanted to liquidate their interests in the partnership. W and X located a buyer, A, and executed the sale through the following series of steps. First, a third party made a loan to the partnership (the "Year 3 Loan"), which was guaranteed by X's corporate parent, Z. As part of the loan agreement, the lender agreed to release the partnership and W from any liability on the loan when X withdrew from the partnership. Second, W transferred a portion of its interest in the partnership to its wholly owned subsidiary, V. Third, W and X amended the partnership agreement to provide that X could withdraw from the partnership by receiving a liquidating distribution of the partnership's operating assets and liabilities, including the Year 3 Loan. Fourth, A acquired X by having Z exchange its stock in X for stock of A's subsidiary. Fifth, according to the partnership agreement, X received the partnership's operating assets and liabilities, including the Year 3 Loan, in liquidation of its interest in the partnership. The partnership retained only cash and notes receivable from other third parties. In connection with

the liquidation of X's interest, the third party lender agreed with the partnership and X to look only to X for repayment of the Year 3 Loan.

(2) Issues and Conclusions

Whether the transactions constitute a disguised sale of property from the partnership to X? Yes. Alternatively, whether the transactions constitute a disguised sale of partnership interests from W and V to X? Yes.

(3) Rulings

Exactly like TAM 200301004 and TAM 200037005, the CCA reviewed section 707(a)(2)(B) and its legislative history, and it applied the same three-pronged approach for purposes of determining a disguised sale of property and a disguised sale of a partnership interest. After finding a disguised sale of property from the partnership to X, the CCA concluded that (i) the same three-pronged analysis applied for disguised sales of partnership interests and (ii) since the transactions satisfied the three-pronged analysis for purposes of a disguised sale of property, they necessarily satisfied the same test for purposes of a disguised sale of partnership interests. However, the CCA did not include a separate discussion of why the three-pronged analysis was satisfied with respect to a disguised sale of partnership interests. Thus, the CCA suggested that the three prongs were satisfied as follows. The first prong was satisfied by reason of the transfer of the Year 3 Loan from the partnership to X, since this amounted to a deemed contribution of cash to the partnership by X due to X's express assumption of the Year 3 Loan. The second prong also was satisfied by X's express assumption of the Year 3 Loan, which relieved W and V from any liability on the loan (i.e., W and V received a deemed distribution of

cash from the partnership under section 752(b)). The third prong was satisfied by reason of the fact that the contributions and distributions caused a permanent equity shift from W and V to X of the partnership's historic operating assets. "When Partnership distributed the Year 3 loan and the Partnership's historic business in redemption of X's interest, a permanent shift in the equity ownership of Partnership and its historic business occurred. The transactions were in substance a sale of W's and V's . . . share of Partnership's business to X undertaken through related contributions to and distributions from Partnership, the kind of transaction that section 707(a)(2)(B) is intended to prevent." Finally, the CCA concluded that, in the exact manner as in TAM 200301004 and TAM 200037005, the National Office could enforce section 707(a)(2)(B) in the context of a disguised sale of a partnership interest despite the absence of regulations.[3]

d) FSA 200024001 (Feb. 8, 2000) (disguised sale of partnership interest)

(1) Facts

Three corporations, Q, U, and R, formed a partnership, PS. Several years later, Q, U, and R executed a redemption agreement. The agreement provided that Q's partnership interest in PS would be redeemed in full on September 30 of Year 5 for cash and a right to future payments based on the profits of PS after the redemption. The parties agreed that the redemption would be treated as a distribution from PS to Q under section 731. The agreement permitted the parties, by election, to restructure the redemption as a sale of Q's partnership interest. On September 20, Year 5, R and U agreed that U would make cash contributions to PS for the purpose of funding PS's redemption payments to Q. The FSA addressed the issues as if the transactions occurred in accordance with the redemption and contribution agreements.

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[3] Note that this CCA was written by the author of the property regulations.

(2) Issue and Conclusion

Whether the transactions constitute a disguised sale of Q's interest in PS to U? Yes.

(3) Ruling

The FSA introduced its analysis by reviewing sections 707(a)(2)(B) and 731 and the related regulations under section 731. The FSA provided: "Subchapter K was adopted in part to increase flexibility among partners in allocating partnership tax burdens. I.R.C. § 701-776; Foxman v. Commissioner, 41 T.C. 535, 550-51 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965). This flexibility, however, is limited by the overarching principle that the substance of the transaction is controlling for tax purposes. Twenty Mile Joint Venture, PND, Ltd. v. Commissioner, 2001-1 U.S.T.C. (CCH) ¶ P50, 124 (10th Cir. 1999), aff'g in part and appeal dismissed in part, T.C. Memo. 1996-283; Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793, 813-14 (1988). The economic substance of the transaction, and not the form, determines its characterization. Treas. Reg. § 1.707-1(a); Jacobson v. Commissioner, 96 T.C. 577, 587-88 (1991), aff'd, 963 F.2d 218 (8th Cir. 1992) . . . . To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945)." The FSA noted that the form of the transaction was a liquidation of Q's interest in PS. However, the FSA warned: "The court, however, will look behind the chosen form of a transaction where 'elements of artificiality' are present. The presence of such elements can be ascertained by looking at the business purpose for the transaction. Jacobson, 96 T.C. at 590." The FSA found two elements of artificiality. The first

element of artificiality was that the funds used to terminate Q's interest in PS were derived from U rather than from PS. The second element of artificiality was that the continuing partners, R and U, did not increase their interests in PS proportionally upon the withdrawal of Q. Rather, U increased its interest but R's interest remained the same, similar to the facts in Colonnade where the court found a disguised sale of a partnership interest. The FSA concluded that a reasonable inference could be drawn that the overarching business purpose for the transaction was to sell Q's interest in PS to U, and, thus, pursuant to section 707(a)(2)(B), the transactions should be treated as a disguised sale of a partnership interest from Q to U.

e) CCA 200224007 (Feb. 27, 2002) (disguised sale of partnership interest)

(1) Facts

Two unrelated corporations, TP and Company, enter into an international joint venture through their wholly owned subsidiaries, CFC1 and CFC2, respectively. As part of the venture, CFC1 and CFC2 are partners in a partnership, UTP. Also, CFC1, CFC2, and UTP are partners in another partnership, LTP. TP and Company enter into an agreement to sell CFC1's interests in UTP and LTP to CFC2. Just prior to consummating the sale transaction contemplated by the agreement, TP received advice proposing an alternative transfer structure that would not result in any subpart F income. The alternative structure called for three steps, which were memorialized in an agreement between the parties. First, CFC1 and CFC2 would contribute their interests in LTP to UTP (causing LTP to be wholly owned by UTP and to be treated as a disregarded entity). Second, UTP would sell its assets (including its interest in LTP) to CFC2. Third, UTP would liquidate. When the transactions occurred, UTP sold its assets to

CFC2 in exchange for two notes. When UTP liquidated, one of the notes was distributed to CFC1 and the other was distributed back to CFC2.

(2) Issues and Conclusions

Applying the step transaction doctrine, should this transaction be recharacterized as a sale of partnership interests? Yes. Even if the step transaction doctrine does not apply, should the last two steps of the transaction be treated as a sale of CFC1's interest in UTP to CFC2? Yes.

(3) Rulings

The CCA first addressed whether the transactions should be recharacterized under the step transaction doctrine. The CCA stated: "[I]t is not enough that the taxpayer could conceive a multi-step process to achieve the same result as a direct sale of partnership interests. Under the judicial step-transaction doctrine, an interrelated series of transactions will be treated as component parts of an overall plan rather than being evaluated separately. The step-transaction doctrine has been described as another rule of substance over form that 'treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result.' Penrod v. Commissioner, 88 T.C. 1415, 1428. See also Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938) ('A given result at the end of a straight path is not made a different result because reached by following a devious path.'). There are three distinct formulations of the step-transaction doctrine. The three formulations are as follows: (1) the end result test, (2) the mutual interdependence test, and (3) the binding commitment test. Under the end result test, a series of transactions are stepped together if they are prearranged parts of a single transaction intended from the outset to reach a

specific end result. Penrod, 88 T.C. at 1429. The end result test focuses on the actual intent of the parties at the beginning of the series of transactions. Under the binding commitment test, a series of transactions will be stepped together if there is a binding commitment to undertake the later steps. Commissioner v. Gordon, 391 U.S. 83 (1968). Under the mutual interdependence test, the separate steps are analyzed to determine if the legal relationships created by one transaction would be fruitless without the completion of the entire series of transactions. Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981)."

The CCA noted that the first agreement among the parties indicates the intent of TP and Company to engage in a sale of CFC1's interests in UTP and LTP to CFC2. The CCA also noted that the subsequent agreement amounted to a binding commitment by the parties to undertake a series of steps to arrive at the same end result. The CCA concluded: "Indeed, in the instant case, under any of the step transaction formulations, the transaction would be recharacterized as a sale of the partnership interests."

The CCA then found that, even if the step transaction doctrine did not apply, the last two steps of the transaction (i.e., the sale of UTP's assets to CFC2 and the subsequent liquidation of UTP) should be treated as a sale of CFC1's interest in UTP to CFC2. The CCA applied a traditional substance over form approach. The CCA seemed to focus on the following facts: (i) the parties had originally agreed to sell CFC1's interest in UTP to CFC2, (ii) the only asset distributed by UTP to CFC1 in UTP's liquidation was a note with a principal amount equal to the amount by which CFC2 and Company had originally agreed to buy CFC1's interest in UTP, and (iii) the note distributed by UTP to CFC1 originated from Company, CFC2's parent, rather than UTP. Notably, the CCA did not rely upon section 707(a)(2)(B) for its conclusions.

B. Proposed Interest Regulations

On November 24, 2004, the Service and the Treasury issued proposed Treasury regulations regarding disguised sales of partnership interests (i.e., the proposed interest regulations). See 69 Fed. Reg. 68838 (Nov. 26, 2004). On February 23, 2009, the Service and the Treasury, in response to practitioner comments, formally announced that the proposed interest regulations had been withdrawn. See IRS Ann. 2009-4, 2009-8 I.R.B. 597. Commentators had criticized the proposed interest regulations as having the potential to recharacterize a variety of otherwise legitimate nontaxable contribution and distribution transactions between partners and partnerships as taxable disguised sales of a partnership interest. Commentators also viewed the proposed interest regulations as unnecessarily complex and administratively burdensome.

In announcing the withdrawal of the proposed interest regulations, the Service and the Treasury stated that they would continue to study disguised sales of a partnership interest and indicated that they may issue guidance in the future. Id. at 598. Until such guidance is issued, any determination of whether transfers between a partner (or partners) and a partnership is a disguised sale of a partnership interest is based on the statutory language, guidance provided in legislative history, and case law. Id.

Notwithstanding their withdrawal, the proposed interest regulations remain instructive as to the application of section 707(a)(2)(B) in the context of disguised sales of a partnership interest and may provide insight as to potential guidance by the Service in the future. What follows below is a detailed discussion of the rules that were contained in the proposed interest regulations.

1. General Rules

a) Overall Rule

Except as otherwise provided in Former Prop. Treas. Reg. § 1.707-7, if a transfer of money, property, or other consideration (including the assumption of a liability) ("consideration") by a partner (a "purchasing partner") to a partnership and a transfer of consideration by the partnership to another partner ("selling partner") met the general facts and circumstances test (discussed below), the transfers were treated as a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner. Former Prop. Treas. Reg. § 1.707-7(a)(1).

b) General Facts and Circumstances Rule

The general facts and circumstances test was as follows: A transfer of consideration by a purchasing partner to a partnership and a transfer of consideration by the partnership to a selling partner constituted a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner only if, based on all the facts and circumstances (i) the transfer of consideration by the partnership to the selling partner would not have been made but for the transfer of consideration to the partnership by the purchasing partner (i.e., the "but-for test"); and (ii) in non-simultaneous transfers, the subsequent transfer was not dependent on the entrepreneurial risks of partnership operations (i.e., the "risk test"). Former Prop. Treas. Reg. § 1.707-7(b)(1).

This test was virtually identical to the general rule for disguised sales of property under Treas. Reg. § 1.707-3. However, due to the nature of typical partnership transactions, this

general rule swept more broadly than its counterpart in the property regulations. Most contributions of property occur at the formation of a partnership or are part of a significant expansion of partnership operations. Most distributions of property occur at the liquidation of a partnership or are part of a significant contraction of partnership operations. These events occur rather infrequently. However, contributions of cash and distributions of cash occur frequently throughout the life of a partnership (e.g., as new partners enter and other partners leave). Thus, the general rule in the proposed interest regulations stood to sweep more broadly, because it would have captured the relatively infrequent property transactions along with the more frequent cash transactions.

Furthermore, the use of the same general facts and circumstances test as the property regulations seemed to ignore the typical structure of a disguised sale of a partnership interest. Transfers that constitute disguised sales of property usually involve only one partner and the partnership (i.e., a two-party transaction). Transfers that constitute disguised sales of partnership interests generally involve a transfer between one partner and the partnership and another transfer between another partner and the partnership (i.e., a three-party transaction).

In rejecting two proposals aimed at narrowing the general facts and circumstances test, the drafters of the proposed interest regulations refused to recognize this intrinsic difference between disguised sales of property and disguised sales of partnership interests. The first proposal would have added to the existing proposed facts and circumstances test a “directly related” component. Under the proposal, in order for two transfers to be considered a sale of a partnership interest, the two transfers must have been directly related to each other. The second proposal would have added an additional “but-for test.” Under this proposal, in order for two transfers to be considered a sale of a partnership interest, the transfer to and the transfer from the

partnership would not have been made but for the other transfer. The Service and the Treasury indicated that they rejected the first proposal due to their belief that a "directly related" requirement would not add any certainty to the disguised sale inquiry, and the second proposal was rejected due to the belief that it would narrow too much the general facts and circumstances test. The Service and the Treasury indicated that the appropriate way to narrow the general facts and circumstances test was to provide additional safe-harbors from such test.

c) Facts and Circumstances Inquiry

All facts and circumstances were taken into account in applying the general facts and circumstances test. Former Prop. Treas. Reg. § 1.707-7(b)(2). The weight to be given each of the facts and circumstances depended on the particular case. Id. Generally, the facts and circumstances existing on the date of the earliest of the transfers were the ones considered in determining if a disguised sale existed. Id. The proposed interest regulations provided a nonexclusive list of facts and circumstances that tended to prove the existence of a disguised sale. They were similar to the list in the property regulations with some additions. Like the property regulations, the proposed interest regulations did not indicate (either by rule or example) whether any one listed fact or circumstance was sufficient to find a disguised sale. Like the property regulations, the proposed interest regulations also did not indicate what types of facts and circumstances tended to prove that a disguised sale did not exist (i.e., only negative factors were listed). Although a taxpayer might assume that proving that the listed negative factors did not exist would prevent a disguised sale finding, the proposed interest regulations did not contain such a rule.

(1) <u>Listed Facts and Circumstances Tending to Prove Disguised Sale</u>

(a) The timing and amount of all or any portion of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer.

(b) The person receiving the subsequent transfer has a legally enforceable right to the transfer or that the right to receive the transfer is secured in any manner, taking into account the period for which it is secured.

(c) The same property (other than money, including marketable securities treated as money under section 731(c)) that is transferred to the partnership by the purchasing partner is transferred to the selling partner.

(d) Partnership distributions, allocations, or control of operations are designed to effect an exchange of the benefits and burdens of ownership of transferred property (other than money, including marketable securities treated as money under section 731(c)), including a partnership interest.

(e) The partnership holds transferred property (other than money, including marketable securities treated as money under section 731(c)) for a limited period of time, or during the period of time the partnership holds transferred property (other than money, including

marketable securities treated as money under section 731(c)), the risk of gain or loss associated with the property is not significant.

(f) The transfer of consideration by the partnership to the selling partner is disproportionately large in relationship to the selling partner's general and continuing interest in partnership profits.

(g) The selling partner has no obligation to return or repay the consideration to the partnership, or has an obligation to return or repay the consideration due at such a distant point in the future that the present value of that obligation is small in relation to the amount of consideration transferred by the partnership to the selling partner.

(h) The transfer of consideration by the purchasing partner or the transfer of consideration to the selling partner is not made pro rata.

(i) There were negotiations between the purchasing partner and the selling partner (or between the partnership and each of the purchasing and selling partners with each partner being aware of the negotiations with the other partner) concerning any transfer of consideration.

(j) The selling partner and purchasing partner enter into one or more agreements, including an amendment to

the partnership agreement (other than for admitting the purchasing partner) relating to the transfers.

(2) <u>What About Different Types of Interests in a Partnership?</u>

In some of the pre-section 707(a)(2)(B) case law, a factor not indicative of a disguised sale was the fact that the purchasing partner could not have acquired the partnership interest that it received from the partnership from the selling partner since (i) the selling partner owned a different type of partnership interest, (ii) the selling partner owned no partnership interest at the time of the relevant transfers, or (iii) the selling partner did not want to give up the rights attendant to the partnership interest that it owned (e.g., voting rights).

In <u>Jupiter Corp. v. United States</u>, 2 Cl. Ct. 58 (1983), the Claims Court found no disguised sale of a partnership interest since, among other factors, (i) the type of limited partner interest the new partners wanted (i.e., preferred interests) did not exist prior to their admission (so, the existing partners could not have sold such an interest to the new partners even if they had wished to do so), and (ii) the type of partnership interest the existing general partner had was not the type that he wanted to sell (or that the limited partners wanted to purchase) since the general partner did not want to share his management rights with another general partner (and the new limited partners did not want to manage the partnership).

In <u>Harris v. Commissioner</u>, 61 T.C. 770 (1974), the Tax Court found no disguised sale of a partnership interest. The court found significant the fact that the purported selling partner did not own a partnership interest at the time the Commissioner argued such partner sold a partnership interest to a third party.

The general rule in Former Prop. Treas. Reg. § 1.707-7(b)(2) provided that all facts and circumstances were required to be taken into account in a disguised sale analysis. Although the legislative history of section 707(a)(2)(B) appears to express disagreement with the result of Jupiter, the legislative history does not address the specific areas of the court's analysis in Jupiter in which it disagrees. The legislative history does not mention Harris. Thus, it appears that the legislative history of section 707(a)(2)(B) should not work to diminish the importance of this factor in a disguised sale analysis.

However, note that this factor may not be sufficient by itself to avoid a disguised sale of a partnership interest. The Commissioner could take the position that a partner in the same position as the existing general partner in Jupiter should be treated first as partially recapitalizing its interest in the partnership so that it owns the particular type of partnership interest that the purchasing partner acquired from the partnership, which is then sold by the selling partner to the purchasing partner.

(3) Non-Tax Business Purpose Requirement?

Although the listed facts and circumstances did not include "the lack of a non-tax business purpose," the general rule still provided that all facts and circumstances had to be taken into account. Former Prop. Treas. Reg. § 1.707-7(b)(2). In Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971) (disguised sale of a partnership interest), and Jacobson v. Commissioner, 96 T.C. 577 (1991), aff'd per curiam, 963 F.2d 218 (8th Cir. 1992) (disguised sale of property), the courts considered the lack of a non-tax business purpose for the related transfers to be a significant factor in finding disguised sales. In Crenshaw, one of the factors the court found significant in finding a disguised sale of a partnership interest was the fact that the parties failed

to show "any conceivable legitimate business purpose" for the chosen form of the transactions. In Jacobson, the Tax Court applied the same analysis that it had in Otey. Thus, the court determined whether the substance of the transactions comported with their form by reviewing all the facts and circumstances. Citing Gregory v. Helvering, 293 U.S. 465 (1934), the court ruled that, in determining the substance of the transactions, the existence or lack of a non-tax business purpose was crucial. "[I]n order for the nonrecognition provisions of section 721 and 731 to apply in this case, there must have been a valid business purpose (or purposes) supporting the contribution . . . and the distribution . . . ." In a footnote, the court further stated that, although in Otey and its progeny the court did not expressly state that it was applying a business purpose requirement, "the factors we have discussed [in such cases] represent facts which indicate the presence or absence of a valid business purpose." Among other facts, the court found significant the fact that the only business purpose for the relevant transfers was to sell the contributed real property for cash (rather than to contribute the property to the partnership in order for the partnership to use it in its business). See also Jupiter Corp. v. United States, 2 Cl. Ct. 58 (1983) (finding no disguised sale of a partnership interest, because, among other facts, there was no evidence that the parties had chosen the form of the transactions to yield better tax results); FSA 200024001 (Feb. 8, 2000) (finding a disguised sale of a partnership interest).

In the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, the staff of the Joint Committee on Taxation suggested that the lack of a non-tax business purpose should be a negative factor in a disguised sale analysis, but the existence of a non-tax business purpose (even a significant one) should not be a positive factor in such an analysis. The staff stated, "[F]urther factors indicating the existence of a disguised sale include . . . the apparent tax motivation of the contributor of property in structuring the transaction as a

contribution of property to the partnership. However, the existence of significant non-tax motivations for becoming a partner is of no particular relevance in establishing that a transaction is not a disguised sale." JCS-41-84 (Dec. 31, 1984). But note that the property regulations appear (as did the proposed interest regulations) to take the position that the 1984 Blue Book does not constitute part of "the legislative history of [section 707(a)(2)(B)]." See Treas. Reg. § 1.707-9(a)(2); Former Prop. Treas. Reg. § 1.707-9(a)(2).

Thus, in light of this (at least arguably) "legislative history," the cases addressed above, and the broad general rule that all facts and circumstances must be considered in the disguised sale analysis, the lack of (and possibly the existence of) a business purpose for the relevant transfers to and from the partnership should be a significant fact and circumstance to consider in a disguised sale analysis.

2. Presumptions and Safe-Harbors

a) Two-Year Presumptions

Consistent with the general framework of the proposed interest regulations, the drafters included two presumptions based on the amount of time between transfers. As discussed in more detail below, if transfers were made within two years, it was presumed that the transfers constituted a disguised sale of a partnership interest, and, if transfers were not made within two years, it was presumed that the transfers did not constitute a disguised sale of a partnership interest. Former Prop. Treas. Reg. § 1.707-7(c), (d). If either of the presumptions were met, only facts and circumstances that clearly established otherwise could have rebutted the presumptions. Id. As a result, the presumptions effectively operated as substantive rules, except

in the rare cases involving straightforward factual circumstances that permitted taxpayers or the Service to meet the “clearly establish” standard.

In the disguised sale of property context, this approach appears to be acceptable to taxpayers due to the relative few instances where transfers may constitute a disguised sale of property. However, in the disguised sale of a partnership interest context, this approach would appear to create major problems for taxpayers due to the greater number of instances where transfers could trigger a presumption that a disguised sale of a partnership interest occurred. It appears that the issues regarding the scope of the general facts and circumstances test (discussed above) become particularly acute in light of these presumptions. If it were not for the two-year presumption in favor of disguised sale treatment, a taxpayer may not be as concerned that two seemingly unrelated transfers might raise the specter of disguised sale treatment, since the taxpayer would not be faced with the rather formidable task of overcoming a presumption in favor of such treatment (i.e., taxpayers may not be as concerned with a broader general rule if the general rule were not buttressed by such a strong two-year presumption for disguised sale treatment).

The drafters of the proposed interest regulations rejected a proposal to eliminate the timing presumptions or apply them only to “extraordinary” transfers. They explained that, “[e]ven though timing presumptions do not eliminate the need to analyze the relevant facts and circumstances, the IRS and the Treasury Department believe that timing presumptions help the IRS and taxpayers identify transactions where closer scrutiny is required.” To the contrary, it appears that the two-year presumption in favor of disguised sale treatment would have effectively eliminated the need for the Service and Treasury to scrutinize the transaction further. The presumption operated against the taxpayer unless the taxpayer clearly established otherwise.

The Service and Treasury apparently did not need to demonstrate anything other than the fact that the transfers occurred within two years. There would appear to be no need for the Service or Treasury to scrutinize the facts and circumstances in a closer manner.

(1) Transfers Within Two Years

The proposed interest regulations provided the following two-year presumption in favor of disguised sale treatment. "[I]f within a two-year period a purchasing partner transfers consideration to a partnership and the partnership transfers consideration to a selling partner (without regard to the order of the transfers), the transfers are presumed to be a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfers do not constitute a sale." Former Prop. Treas. Reg. § 1.707-7(c). As stated in the regulations, this presumption could have been rebutted with facts and circumstances that clearly established otherwise.

This presumption also could have been avoided by arguing that either of the two relevant transfers qualified for some other presumption or exception in the proposed interest regulations, such as the cash liquidation presumption or the exceptions for guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures (discussed below). This aspect of the two-year presumption provided some relief to taxpayers.

However, the prospect that this two-year presumption may be avoided by meeting certain presumptions or exceptions did not alleviate the need for partnerships to monitor all contributions and distributions within a rolling four-year period in order to determine whether the two-year safe-harbor in favor of disguised sale treatment applied and whether any offsetting

presumptions or safe-harbors applied. This would have increased the cost of conducting business in any entity treated as a partnership, particularly those businesses that involve frequent transfers of cash to and from their investors/owners (such as private equity funds and family-owned businesses).

(2) Transfers Outside Two Years

The proposed interest regulations also provided the following two-year presumption against disguised sale treatment. "[I]f a transfer of consideration by a purchasing partner to a partnership and the transfer of consideration by the partnership to a selling partner (without regard to the order of the transfers) occur more than two years apart, the transfers are presumed not to be a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfers constitute a sale." Former Prop. Treas. Reg. § 1.707-7(d). As stated above, this presumption could have been rebutted with facts and circumstances that clearly established otherwise.

Note that arguing that the two-year presumption in favor of a disguised sale should be eliminated almost certainly would have caused the Service and Treasury to take the position that the taxpayer-friendly two-year presumption against disguised sale treatment should be eliminated in order to maintain a level playing field. Query whether the benefit of eliminating the two-year presumption for disguised sale treatment outweighed the cost of losing the favorable two-year presumption against disguised sale treatment.

b) Cash Liquidation Presumption

The Service and the Treasury stated in the preamble to the proposed interest regulations that the "abuse that section 707(a)(2)(B) was intended to address typically is not present in situations involving complete liquidations of partners' partnership interests for money." Accordingly, the proposed interest regulations contained another presumption against disguised sale treatment. "[I]f a partnership transfers money, including marketable securities that are treated as money under section 731(c)(1), to a selling partner, or is treated as transferring consideration to the selling partner [due to the assumption of a partner liability by the partnership], in liquidation of the selling partner's interest in the partnership, the transfer is presumed not to be a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfer is part of a sale." Former Prop. Treas. Reg. § 1.707-7(e).

If there is enough risk of disguised sale treatment with the distribution of property in liquidation of a partner's interest in the partnership, this presumption appeared to permit the partnership to sell the property for cash to a third party and to distribute the cash proceeds in liquidation of the partner's interest in the partnership. However, it appears that, due to the "facts and circumstances clearly establish otherwise" exception to the presumption, such presumption may not have applied if an agreement to distribute property (rather than cash) had been entered into before the property sale and cash liquidation transaction.

c) Guaranteed Payments, Preferred Returns, Operating Cash Flow Distributions, and Reimbursements of Preformation Expenditures

Notwithstanding the two-year presumption in favor of disguised sale treatment, rules similar to the property regulations regarding guarantee payments, preferred returns,

operating cash flow distributions, and reimbursements of preformation expenditures applied in determining the extent to which a transfer to a selling partner was treated as part of a sale of the selling partner's interest in the partnership to the purchasing partner. The preamble stated that the extension of these rules to the disguised sale of a partnership interest context was appropriate, since these rules remove transfers to partners that occur in the ordinary course of business from the disguised sale analysis.

3. Exceptions

a) Service Partnerships

Transfers of money (including marketable securities treated as money under section 731(c)(1)) to and by a "service partnership" were excepted from section 707(a)(2)(B) and the proposed interest regulations. Former Prop. Treas. Reg. § 1.707-7(g). The preamble stated: "This exception takes into account that partners frequently enter and exit service partnerships and, in most cases, those transactions are factually unrelated to each other and should not be treated as a disguised sale of a partnership interest." However, this exception appeared to have a much broader application, because the exception explicitly stated that "section 707(a)(2)(B)" did not apply to such transfers. The reference to section 707(a)(2)(B) presumably made the exception applicable to all transactions covered by section 707(a)(2)(B), including disguised sales of property transactions. However, this presumed breadth may have been illusory, since this exception was located in a proposed Treasury regulation devoted exclusively to disguised sales of partnership interests, and there already exists detailed Treasury regulations devoted exclusively to disguised sales of property.

For purposes of this exception, a "service partnership" was defined as a partnership that would be described in section 448(d)(2) (i.e., the qualified personal service corporation rules) if the partnership were a corporation, partners were treated as employees of the partnership, and ownership of interests in the partnership were treated as ownership of stock. In order for a service partnership to have relied upon this exception, it would have had to monitor continually its activities and its ownership structure to ensure that the section 448(d)(2) "function test" and the "ownership test" were satisfied. See Temp. Treas. Reg. § 1.448-1T(e)(3). Note that the "function test" and the "ownership test" for qualification as a qualified personal service corporation under section 448(d)(2) utilize 95 percent thresholds, which leaves little room for error. With respect to any taxable year of a corporation, the "function test" is satisfied only if 95 percent or more of the time spent by employees of the corporation during such year is devoted to the performance of services in a qualifying field (e.g., health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting). Temp. Treas. Reg. § 1.448-1T(e)(4). With respect to any taxable year of a corporation, the "ownership test" is satisfied only if, at all times during such taxable year, 95 percent or more of the stock of the relevant corporation is owned (directly or indirectly) by employees performing services in a qualified field for the corporation, former employees that performed such services, the estate of any current or former employee that performed such services, and any person who acquired the stock of such corporation by reason of the death of any current or former employee that performed such services but only for a period of two years after the death of such employee. Temp. Treas. Reg. § 1.448-1T(e)(5).

The preamble to the proposed interest regulations requested comments regarding whether transfers to and from other types of partnerships should have been excepted from the

regulations as well. Some types of partnerships that ordinarily engage in multiple transfers of cash or property with their partners are (i) private equity funds in which investors enter and exit periodically, (ii) partnerships engaged in improving real property or operating a rental real estate business, and (iii) partnerships operating family businesses in which the business serves as the primary source of funds in which to pay business expenses and personal expenses of the family member partners. Although application of the proposed interest regulations to these types of partnerships should have been limited, a blanket exception for such partnerships might have invited abuse. Therefore, a rebuttable presumption against disguised sale treatment for all transfers to and from such partnerships would have been an appropriately balanced approach (i.e., most of such transfers are not effected to disguise a sale of a partnership interest, but, in limited cases, taxpayers could artificially use certain transfers to effect such a sale).

b) Partnership Formations

Transfers incident to the formation of a partnership were excepted from the proposed interest regulations. Former Prop. Treas. Reg. § 1.707-7(a)(8). Like the service partnership exception, this exception also referred to transfers being excepted from "section 707(a)(2)(B)," which presumably broadened its reach to disguised sales of property. However, unlike the service partnership exception, the proposed interest regulations explicitly provided that transfers incident to the formation of a partnership may be transfers to which the property regulations apply.

Neither the proposed interest regulations nor their preamble indicated what transfers were considered "incident to the formation of a partnership." Did this mean that only the first transfers of money or property to a partnership were excepted? Did this mean that all

transfers of money or property to a partnership during the year the partnership begins conducting business were excepted?

This exception could be viewed as a manifestation of the Tax Court's ruling in Jacobson. In Jacobson, a general partnership ("JWC") owned real property. For the two years prior to 1982, JWC had been trying to sell the real property. In 1982, JWC was introduced to an insurance company ("M") that was willing to enter into a transaction that effectively transferred 75 percent of the real property to M in exchange for cash. JWC and M, with the help of their tax attorneys, consummated the following transaction in 1982. JWC contributed 100 percent of the real property to a new general partnership in exchange for a 25 percent interest in the partnership. At the same time, M contributed cash equal to 75 percent of the fair market value of the real property to the partnership in exchange for a 75 percent interest in the partnership. Immediately thereafter, the partnership distributed all of the contributed cash to JWC.

The Commissioner argued that the contribution of real property followed by the distribution of cash constituted a disguised sale of 75 percent of the real property from JWC to M followed by JWC and M contributing 25 percent and 75 percent of the real property, respectively, to the partnership. The Commissioner also appeared to argue in the alternative that the contribution and distribution should be treated as a disguised sale of 75 percent of the real property from JWC to the partnership under section 707(a). The partners of JWC argued that the contribution and distribution should be tax-free under sections 721 and 731, respectively.

The Tax Court agreed with the Commissioner's primary argument and held that the contribution and distribution should be treated as a disguised sale of 75 percent of the real property from JWC to M followed by JWC and M contributing 25 percent and 75 percent of the real property, respectively, to the partnership.

The Commissioner may have argued that the transactions should be treated as a contribution of 100 percent of the real property by JWC followed by a sale of 75 percent of JWC's interest in the partnership to M for the cash M contributed to the partnership. However, this recast would have included a fiction not permitted under the Code (i.e., a one-partner partnership). Under this recast, the contribution of cash by M would not have been regarded for Federal tax purposes, and, therefore, the partnership would have had only one partner (i.e., JWC) for a moment in time before the disguised sale of a 75 percent interest in the partnership to M. The Commissioner undoubtedly realized this flaw in such a recast and wisely argued for recasts that did not include a fictitious one-partner partnership.

Further, the court's holding in Jacobson highlights the fact that transfers incident to the formation of a partnership can constitute disguised sales of property between a partner and a partnership or between partners. Thus, exclusion from the proposed interest regulations was of some benefit, but it certainly did not eliminate the overall risk of a disguised sale.

c) Section 708(b)(1)(B) Terminations

Deemed transfers resulting from a termination of a partnership under section 708(b)(1)(B) were excepted from the proposed interest regulations. Former Prop. Treas. Reg. § 1.707-7(a)(8). Like the service partnership exception, this exception also referred to transfers being excepted from "section 707(a)(2)(B)," which presumably broadened its reach to disguised sales of property. However, the deemed transfers resulting from a termination of a partnership (i.e., a deemed transfer of all assets and liabilities to a new partnership followed by the old partnership liquidating by distributing its interest in the new partnership) do not appear to be the

type of transfers that would create a risk of a disguised sale of property. See Treas. Reg. § 1.708-1(b)(4).

d) Section 708(b)(1)(A) Terminations

Even if, after the application of the proposed interest regulations, it was determined that the relevant partnership had terminated under section 708(b)(1)(A), the proposed interest regulations would have applied to the transfers to and from such partnership leading up to its termination. Former Prop. Treas. Reg. § 1.707-7(a)(7). For example, if transfers to and from a partnership were treated as a sale of all of a 20-percent partner's interest in a two-person partnership to the other 80-percent partner, the fact that the partnership terminated upon such deemed sale did not defeat such disguised sale treatment. This rule was consistent with the treatment of the selling partner in the two-partner partnership in situation 1 of Rev. Rul. 99-6, 1999-1 C.B. 432.

e) Application of Property Rules

To the extent that any transfer that would otherwise be taken into account under the proposed interest regulations "may" have been treated as a sale of property under the property regulations, the property regulations were deemed to apply before the proposed interest regulations. Former Prop. Treas. Reg. § 1.707-7(a)(6). This ordering rule apparently meant that the disclosure rules in the property regulations took precedence over the disclosure rules in the proposed interest regulations. Furthermore, to the extent any transfer was treated as part of a disguised sale of property, such transfer was not taken into account in applying the proposed interest regulations. Id. With respect to this aspect of the rule, the preamble stated: "This

ordering rule is appropriate because, in some cases, the tax consequences of a disguised sale of property may be simpler than a disguised sale of a partnership interest because, for example, a disguised sale of property will not result in a technical termination of the partnership under section 708(b)(1)(B) or basis adjustments under section 743(b)."

f) Other Exceptions

In addition to the presumptions, exceptions, and safe-harbors contained in the proposed interest regulations, the Service could have provided formal guidance that section 707(a)(2)(B) and the proposed interest regulations did not apply to other transfers to and by a partnership. Former Prop. Treas. Reg. § 1.707-7(h).

g) Specific Safe-Harbors and Exceptions Not Adopted

The preamble discussed several proposed safe-harbors and exceptions that were not adopted as part of the proposed interest regulations. The proposed interest regulations did not adopt a specific favorable presumption or safe-harbor for transactions involving transfers of different property. The preamble explained that the Service and Treasury were concerned that, if such a favorable presumption or safe harbor were adopted, a purchasing partner and selling partner could "easily structure" a transaction to fit within such a favorable presumption or safe harbor. However, that could be said for the two-year favorable presumption and the exceptions actually adopted in the proposed interest regulations. If the Service and Treasury were comfortable adopting the prophylactic two-year favorable presumption, there appears to be no policy reason why they should not feel the same for adopting a similar favorable presumption regarding transfers involving different property. Presumably, the intended goal of the proposed

interest regulations was to treat transactions that share the same substantive characteristics of an actual sale of a partnership interest as an actual sale of a partnership interest. One of the substantive characteristics of an actual sale of a partnership interest is that the consideration relinquished by the purchaser is the same consideration received by the seller. When the consideration transferred by a partnership to a selling partner and the consideration transferred by a purchasing partner to the partnership are not the same, the consideration relinquished by the purchasing partner and the consideration received by the selling partner differ. Thus, one of the hallmarks of an actual sale of a partnership interest does not exist. At the least, transfers involving different property should be presumed not part of a disguised sale of a partnership interest subject to facts and circumstances clearly establishing otherwise. The type of transactions that the Service and Treasury were apparently concerned about (i.e., transactions structured solely to fit within such a favorable presumption) would not be safe under such a favorable presumption. In those cases, the Service would be given the opportunity to prove that certain facts and circumstances clearly establish that the transfers were part of a disguised sale of a partnership interest.

The Service and Treasury also declined to adopt a safe harbor for situations in which one partner funds a defaulting partner's obligation to make a capital contribution and the defaulting partner later cures its default, since they believed that such transactions "can be difficult to distinguish from an actual sale of a partnership interest." Transfers to and from a partnership with respect to funding a defaulting partner's obligations to the partnership are made so that the partnership can meet its immediate business needs without having to borrow from third parties (or default on its own obligations) and to restore (after the defaulting partner cures its default) the partners to the economic positions they were in prior to the default. Such

transfers are not made with the intent of disguising a sale of a partnership interest from one partner to another. They are made with the intent of preserving the very existence of the partnership and are contingent on one partner actually defaulting on its obligations to the partnership. At the least, transfers to and from a partnership incident to one partner funding a defaulting partner's obligation to make a capital contribution and the defaulting partner later curing its default should be presumed not part of a disguised sale of a partnership interest (subject to facts and circumstances clearly establishing otherwise). Like the situation involving transfers of different property, the Service would be given the opportunity to prove that certain facts and circumstances clearly establish that certain transfers actually were part of a disguised sale of a partnership interest.

4. Special Rules Regarding Liabilities

The proposed interest regulations generally followed the approach of the property regulations with respect to the treatment of liabilities. However, there was a significant difference. Unlike the property regulations, the proposed interest regulations did not include any special rules for "qualified liabilities." The preamble stated "qualified liability" rules were omitted, since a transfer to a partnership of encumbered property alone would not have been subject to recharacterization as a disguised sale of a partnership interest, but such a transfer alone could have been subject to recharacterization as a disguised sale of property. Although such a difference in treatment exists with respect to a transfer of encumbered property, this difference does not appear to justify the omission of "qualified liability" rules in the proposed interest regulations. The application of "qualified liability" rules in the property regulations generally serves to exclude from the disguised sale analysis the deemed distribution of cash from the relief

of a partner liability upon the transfer of such liability and property encumbered by such liability where the partner liability effectively was not incurred to permit the partner to extract equity from the contributed property prior to its contribution. Such rules do not exclude the actual contribution of the encumbered property from the disguised sale analysis (i.e., the property contribution itself still could be coupled with another transfer to create a disguised sale of property). See, e.g., Treas. Reg. § 1.707-5(a)(5). Thus, extending the "qualified liability" rules to the disguised sale of partnership interest context would not have caused the transfer of encumbered property to be disregarded. At most, only the deemed distribution of cash from the relief of the encumbrance would have been disregarded. The actual transfer of the property still could have formed part of a disguised sale of a partnership interest under the proposed interest regulations.

Furthermore, not extending the "qualified liability" rules to the disguised sale of partnership interest context produced inappropriate results under the proposed interest regulations. For example, assume A and B form an equal general partnership in 2008. In 2009, A contributes property worth $100 that is subject to a $20 liability that was incurred more than two years ago to construct $20 of improvements on the property, and B contributes $80 so as to maintain the same 50:50 sharing ratio. A's contribution of property is not a disguised sale of the property to the partnership, since the relief of $10 of the liability to which the property is subject is disregarded under the "qualified liability" rules of the property regulations. See Treas. Reg. § 1.707-5(a)(5), (6). However, the relief of $10 of the liability is not disregarded for purposes of applying the proposed interest regulations. Thus, since B transferred $80 of consideration to the partnership, and (at the same time) A is treated as receiving $10 of consideration from the partnership, the proposed interest regulations presume that A sold $10 of its partnership interest

to B. This result appears to make no sense. There appears to be no policy reason why the contribution of encumbered property should trigger a disguised sale of a partnership interest in this situation where such contribution will not trigger a disguised sale of property. See infra Example 10.

a) Reallocation of Partnership Liabilities

Under current law, it is unclear whether a deemed contribution or distribution of money pursuant to section 752 should be taken into account in a disguised sale of a partnership interest analysis. The property regulations comprehensively speak to the issues raised by partnership indebtedness but notably do not suggest that a shift of partners' shares of partnership liabilities can be treated as a contribution or distribution for purposes of section 707(a)(2)(B). See Treas. Reg. § 1.707-5.

Section 707(a)(2)(B) clearly provides that "indirect" transfers of property between a partner and a partnership should be taken into account, which arguably could include deemed contributions and distributions of money pursuant to section 752. However, while the shift of partnership liabilities is often described as a "deemed" contribution or distribution, it does not seem to be an "indirect" contribution or distribution, because the deemed transaction is treated as made directly between the partner and the partnership. An "indirect" contribution seems more apt in describing a payment made, for example, by a partner on behalf of a partnership to a third party, and an "indirect" distribution seems more apt in describing a payment made, for example, by a partnership on behalf of a partner to a third party.

Colonnade could be read to support the conclusion that a deemed contribution of money pursuant to section 752 should be taken into account for purposes of determining whether

a disguised sale of a partnership interest occurs under section 707(a)(2)(B). However, the transaction at issue in Colonnade preceded the enactment of section 707(a)(2)(B), and so the opinion did not address the possible interaction of section 752 and the disguised sale rules. Furthermore, Colonnade involved other facts that made the transactions at issue more susceptible to disguised sale treatment. In particular, in Colonnade, the court found significant the fact that the capital of the partnership did not change as a result of the transactions, and that was the same result that would have occurred if the parties had chosen to sell their partnership interests outside the partnership.

In addition to Colonnade, Chief Counsel Advice 200250013 could be viewed as analogous support for the conclusion that a deemed contribution of money pursuant to section 752 should be taken into account for purposes of determining whether a disguised sale of a partnership interest occurs under section 707(a)(2)(B). However, the liability shift in CCA 200250013 occurred when a partner expressly assumed partnership-level debt, and the lender agreed to look only to that partner for repayment.

Counter-balancing Colonnade and CCA 200250013, the legislative history of section 707(a)(2)(B) suggests that the shifting of pre-existing partnership-level liabilities should not be taken into account in addressing a disguised sale issue. See S. Rep. No. 98-169 (1984) ("Similarly, the committee does not intend to change the general rules concerning the tax treatment of the partners under sections 721, 731, and 752 to the extent . . . (2) contributions to a partnership which, because of liabilities of the partnership incurred other than in anticipation of the contribution, result in a deemed distribution under sec. 752(b)."). Further, as described above, the Tax Court in Oehlschlager, suggested that the actual receipt of partnership property (rather than a deemed receipt of cash) was needed to trigger a disguised sale of a partnership

interest, at least under the authority that existed before the enactment of section 707(a)(2)(B), which still exists today (i.e., Treas. Reg. § 1.731-1(c)(3)). The court stated that "the deemed distribution requirement [of section 752] serves to adjust the basis of a partnership interest and not necessarily to substitute for an actual receipt of partnership property for purposes of the deemed exchange rule of the regulations [i.e., Treas. Reg. § 1.731-1(c)(3)]."

In addition to the legislative history of section 707(a)(2)(B) and Oehlschlager, other analogous authorities also suggest that a liability shift should be disregarded for purposes of determining whether a disguised sale of a partnership interest occurs under section 707(a)(2)(B). See Treas. Reg. § 1.704-1(b)(2)(iv)(c) (generally disregarding deemed contributions and distributions of money pursuant to liability shifts under section 752 for purposes of adjusting a partner's capital account); Treas. Reg. § 1.1223-3(b)(3) (disregarding deemed contributions and distributions of money pursuant to liability shifts under section 752 for purposes of determining the holding period of a partner's interest in a partnership); Treas. Dec. 8902 (Oct. 10, 2000) (providing that, for purposes of determining the holding period of a partner's interest in a partnership, deemed contributions and distributions under section 752 as a result of a liability shift at the partnership level should be disregarded to the same extent as they are disregarded under Treas. Reg. § 1.704-1(b)(2)(iv)(c) since "[a] deemed contribution of cash resulting from a shift among partners in their share of liabilities or as a result of a partnership incurring new debt does not expand the net asset base of the partners represented by their interests in the partnership").

Apparently relying on the legislative history of section 707(a)(2)(B) and Oehlschlager (described above), the drafters of the proposed interest regulations explicitly carved out deemed contributions and distributions under section 752 from the disguised sale analysis, at

least in some cases. The proposed interest regulations stated: "[D]eemed contributions to and distributions from a partnership under section 752 resulting from reallocations of partnership liabilities among partners are not treated as transfers of consideration." Former Prop. Treas. Reg. § 1.707-7(j)(1). However, the proposed interest regulations provided further that, if a "transaction" was otherwise treated as a sale of a partnership interest under the proposed interest regulations, any deemed contributions and distributions under section 752 were taken into account. Id. The proposed interest regulations did not provide guidance as to the required relationship between the "transaction" and any particular deemed contribution or distribution under section 752 so as to cause such deemed transfers to be taken into account in determining tax consequences of the "transaction" as a disguised sale of a partnership interest. Presumably, only the deemed contributions and distributions under section 752 arising from the actual transfers of consideration creating the disguised sale of a partnership interest would have been taken into account.

b) Assumption by Partnership

The proposed interest regulations adopted the same rules regarding assumptions of liabilities by partnerships as the rules in the property regulations. If a partnership assumed a liability of a partner (under the rules in Treas. Reg. §§ 1.752-1(d) and (e)), the partnership was treated as transferring consideration to the partner to the extent that the amount of the liability exceeded the partner's share of that liability (as described below) immediately after the partnership assumed the liability. Former Prop. Treas. Reg. § 1.707-7(j)(2). However, if, pursuant to a plan, a partner paid or contributed money to the partnership and the partnership assumed one or more liabilities of the partner, the amount of those liabilities that the partnership

was treated as assuming was reduced (but not below zero) by the money transferred. Former Prop. Treas. Reg. § 1.707-7(j)(7).

If the partnership assumed the liabilities of more than one partner pursuant to a plan, a partner's share of the liabilities assumed by the partnership pursuant to that plan immediately after the assumptions equaled the sum of that partner's shares of the liabilities assumed by the partnership pursuant to the plan. Former Prop. Treas. Reg. § 1.707-7(j)(2). However, this special aggregation rule did not apply to any liability assumed by the partnership with a principal purpose of reducing the extent to which any other liability assumed by the partnership was treated as a transfer of consideration to a partner. Id.

Furthermore, an anti-abuse rule applied in situations where the partners planned to temporarily increase or preserve a partner's share of a partnership liability so as to avoid a disguised sale risk which was followed by a subsequent reduction in the partner's share of such liability. Under this anti-abuse rule, a partner's share of a liability, immediately after a partnership assumed the liability, was determined by taking into account a subsequent reduction in the partner's share if the following two conditions were satisfied: (i) At the time that the partnership assumed a liability, it was anticipated that the transferring partner's share of the liability would have been subsequently reduced; and (ii) The reduction of the partner's share of the liability was part of a plan that had as one of its principal purposes minimizing the extent to which the assumption of the liability was treated as part of a sale. Former Prop. Treas. Reg. § 1.707-7(j)(5).

c) Assumption by Partner

The proposed interest regulations also adopted the same rules regarding assumptions of liabilities by partners as the rules in the property regulations. If a partner assumed a liability of the partnership (under the rules in Treas. Reg. §§ 1.704-1(b)(2)(iv)(c) and 1.752-1(e)), the partner was treated as transferring consideration to the partnership to the extent that the amount of the liability exceeded the partner's share of that liability (as described below) immediately before the partner assumed the liability. Former Prop. Treas. Reg. § 1.707-7(j)(3). However, if, pursuant to a plan, a partnership paid or distributed money to a partner and the partner assumed one or more liabilities of the partnership, the amount of those liabilities that the partner was treated as assuming was reduced (but not below zero) by the money transferred. Former Prop. Treas. Reg. § 1.707-7(j)(7).

If more than one partner assumed a partnership liability pursuant to a plan, the amount that was treated as a transfer of consideration by each partner was the amount by which all of the liabilities assumed by the partner pursuant to the plan exceeded the partner's share of all of those liabilities immediately before the assumption. Former Prop. Treas. Reg. § 1.707-7(j)(3). However, this special aggregation rule did not apply to any liability assumed by a partner with a principal purpose of reducing the extent to which any other liability assumed by a partner was treated as a transfer of consideration to a partnership. Id.

d) Determination of a Partner's Share of Partnership Liabilities

The rules regarding assumptions of liabilities generally provide that transfers of consideration will arise between a partner and the partnership to the extent that a partner's share of a liability changes as a result of an assumption of such liability by either the partner or the

partnership. If a partner's share of the relevant liability does not change as a result of the assumption, the liability will not create a deemed transfer of consideration. Thus, this aspect of the liability rules should be a focal point for any taxpayer engaging in any partnership transaction involving liabilities that has a disguised sale potential.

The proposed interest regulations adopted the same rules regarding the determination of a partner's share of any partnership liability as the rules in the property regulations. A partner's share of a recourse liability of the partnership equaled the partner's share of the liability under section 752 and the Treasury regulations thereunder (i.e., the "economic risk of loss" rules contained in Treas. Reg. § 1.752-2). Former Prop. Treas. Reg. § 1.707-7(j)(4). A partner's share of a nonrecourse liability of the partnership was determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3) (i.e., the "third-tier allocation rule"). Id. Similar to the property regulations, with respect to nonrecourse liabilities, the application of Treas. Reg. § 1.752-3(a)(3) in the disguised sale context was modified so as to prohibit a partner from determining its share of a partnership liability based on its share of excess section 704(c) gain with respect to property that was subject to the relevant partnership liability. Former Prop. Treas. Reg. § 1.752-3(a)(3).

Since the proposed interest regulations used the partnership liability rules under section 752 (as do the property regulations) to determine a partner's share of a partnership liability, most of the general techniques used to preserve or shift a partner's share of a partnership liability (e.g., to avoid recognizing gain due to a deemed distribution of cash in excess of the partner's basis in its partnership interest under section 731) were applicable in the disguised sale context as well. Typical techniques include using guarantees, indemnification

agreements, reimbursement agreements, contribution agreements, or other similar agreements to fix the partners' economic risks of loss for a partnership liability. Often, the specific structure of these techniques includes a "bottom dollar" feature and the use of an entity with limited capitalization. Great care must be taken to ensure that all relevant agreements will be enforceable under the relevant state or foreign law, and that no other contractual or statutory rights of reimbursement or indemnification will take precedence over the rights created in the agreements. Other techniques include using special allocations of profits so that partnership nonrecourse liabilities may be allocated solely to a particular partner under Treas. Reg. § 1.752-3(a)(3).

e) Debt-Financed Transfers of Consideration by Partnerships

The proposed interest regulations adopted the same rules regarding debt-financed transfers of consideration by partnerships as the rules in the property regulations. If a partnership incurred a liability and all or a portion of the proceeds of that liability were allocable under Temp. Treas. Reg. § 1.163-8T to a transfer of consideration to a partner made within 90 days of incurring the liability, the transfer of consideration to the partner was taken into account only to the extent that the amount of consideration transferred exceeded that partner's "allocable share" of the partnership liability. Former Prop. Treas. Reg. § 1.707-7(j)(6). Generally, a partner's "allocable share" of a partnership liability equaled the amount obtained by multiplying the partner's share of the liability under the normal liability-sharing rules (described above) by a fraction determined by dividing (i) the portion of the liability that was allocable under Temp. Treas. Reg. § 1.163-8T to the consideration transferred to the partner by (ii) the total amount of the liability. Id.

For purposes of the preceding rule, if a partnership transferred to more than one partner pursuant to a plan all or a portion of the proceeds of one or more partnership liabilities, all of the liabilities incurred pursuant to the plan were treated as one liability, and each partner's allocable share of those liabilities equaled the amount obtained by multiplying the sum of the partner's shares of each of the respective liabilities (determined under the normal liability-sharing rules (described above)) by the fraction obtained by dividing (i) the portion of those liabilities that was allocable under Temp. Treas. Reg. § 1.163-8T to the consideration transferred to the partners pursuant to the plan by (ii) the total amount of those liabilities. Id. However, the debt-financed transfer rule did not apply to any transfer of consideration to a partner that was made with a principal purpose of reducing the extent to which any transfer was taken into account under the general rule for debt-financed transfers. Id.

A special anti-abuse rule applied to these debt-financed transfers. A partner's share of a liability was determined by taking into account a subsequent reduction in the partner's share if (i) it was anticipated that the partner's share of the liability that was allocable to a transfer of consideration to the partner would have been reduced subsequent to the transfer, and (ii) the reduction of the partner's share of the liability was part of a plan that had as one of its principal purposes minimizing the extent to which the partnership's distribution of the proceeds of the borrowing was treated as part of a sale. Id.

As described above, in order for the debt-financed transfer rule to apply, a partner must have received a distribution of loan proceeds that was allocable under the rules in Temp. Treas. Reg. § 1.163-8T to a liability incurred by the partnership within 90 days of the distribution. Some of the rules under Temp. Treas. Reg. § 1.163-8T that were relevant in applying this rule are as follows. First, if a partnership receives loan proceeds in cash and

transfers any cash (not necessarily the loan proceeds) within 15 days of receipt of such loan proceeds, the partnership can treat the transfer of such cash as allocable to the partnership loan that generated the loan proceeds. Temp. Treas. Reg. § 1.163-8T(c). Second, if the partnership receives loan proceeds and deposits the proceeds in any bank account (e.g., an existing bank account that contains proceeds from other sources), any transfer of cash out of that bank account within 15 days of such deposit will be treated as allocable to the partnership loan that generated the loan proceeds. Id. Third, if the partnership receives loan proceeds and deposits the proceeds in any bank account and the subsequent distribution does not meet the immediately preceding 15-day rule, any transfer of cash out of the account will be treated as allocable to the partnership loan that generated the loan proceeds before such transfer to the extent of any (i) unborrowed amounts deposited in such account at the time the loan proceeds are deposited and (ii) any amounts deposited (i.e., borrowed or unborrowed) in such account after the loan proceeds were deposited. Id. Fourth, the preceding two rules are applied separately to separate bank accounts of the partnership. Id.

In light of these rules, the partnership should have followed either of the following four lending procedures to ensure that it met the debt-financed transfer rule. First, the partnership should have directed the bank to transfer the loan proceeds directly to the partner. Second, the partnership should have received the loan proceeds and immediately transferred the proceeds to the partner. Third, the partnership should have received the loan proceeds, deposited the proceeds into a new bank account, and then transferred cash from the account to the partner within 90 days. Fourth, the partnership should have received the loan proceeds, deposited the proceeds into an existing bank account, and then transferred cash from the account to the partner within 15 days of such deposit. See Temp. Treas. Reg. § 1.163-8T(c).

In order to ensure that no part of the debt-financed transfer of proceeds to a partner was treated as a transfer of consideration for disguised sale purposes, the partner's share of the relevant partnership liability under the general liability-sharing rules (described above) often needed to exceed the ratio of the amount of the liability allocable under Temp. Treas. Reg. § 1.163-8T to the consideration transferred to the partner over the total amount of such liability. Accordingly, most partners could not have relied solely on the general liability-sharing rules for nonrecourse liabilities to avoid any disguised sale risk under the debt-financed transfer rule. Rather, most partners needed to rely on the general liability-sharing rules for recourse liabilities.

For example, assume that a limited liability company borrows $100 from a bank and transfers $80 of such loan proceeds to Member X who shares 80 percent of the profits of the company. Since no member has any economic risk of loss for such liability, the liability is treated as a nonrecourse liability. See Treas. Reg. §§ 1.752-1, -2, -3. Pursuant to Treas. Reg. § 1.752-3(a)(3) and Former Prop. Treas. Reg. § 1.707-7(j), Member A's share of such liability under the general liability-sharing rules was equal to its profit-sharing ratio (i.e., 80 percent). Since Member A received only $80 of the partnership's $100 loan proceeds, Member A's allocable share of the partnership liability was 64 percent -- 80 percent (i.e., the partner's share of the partnership liability under the general liability-sharing rules) multiplied by 80 percent (i.e., Member A's allocable share of such liability). Thus, only $64 of the $80 distribution to Member A was protected from disguised sale treatment under the debt-financed transfer rule. In order to ensure that no part of the $80 transfer was treated as part of a disguised sale, Member A could have guaranteed the entire $100 partnership liability, which would have increased its share of such liability under the general liability-sharing rules from 80 percent to 100 percent.

Note that a guarantee of only 20 percent of such liability would not be sufficient. In that case, Member A's share of such liability under the general liability-sharing rules would have equaled 84 percent (i.e., 20 percent from the guaranteed portion of the liability under the recourse liability rules plus 80 percent of the remaining 80 percent-portion of the liability under the nonrecourse liability rules), and, accordingly, Member A's allocable share of such liability would have equaled 67.2 percent (i.e., 84 percent multiplied by the ratio of the $80 loan proceeds distributed to Member A over the entire $100 of the loan proceeds). Thus, if only 20 percent of the partnership liability were guaranteed by Member A, only $67.20 of the $80 distribution to Member A would have been protected from disguised sale treatment under the debt-financed transfer rule.

f) Anti-Abuse Rule Regarding Liability Rules

Notwithstanding any other rule in the proposed interest rules, an increase in a partner's share of a partnership liability could have been treated as a transfer of consideration by the partner to the partnership if, (i) within a short period of time after the partnership incurred or assumed the liability (or another liability), one or more partners of the partnership (or related parties within the meaning of section 267(b) or section 707(b)), in substance bore an economic risk for the liability that was "disproportionate" to the partner's interest in profits or capital, and (ii) the transactions were undertaken pursuant to a plan that had as one of its principal purposes minimizing the extent to which the partner was treated as making a transfer of consideration to the partnership that may have been treated as part of a disguised sale. Former Prop. Treas. Reg. § 1.707-7(j)(8). Neither the preamble to the proposed interest regulations nor the examples illuminated the purpose or intended target of this anti-abuse rule.

5. Treatment as Disguised Sale

a) Scope of Sale Treatment

Under the proposed interest regulations, transfers that were treated as a sale of a partnership interest under such regulations were treated as a sale for all purposes of the Code. Former Prop. Treas. Reg. § 1.707-7(a)(2)(i). The regulations listed the following sections in which such treatment was relevant: (i) section 453, (ii) section 483, (iii) section 708, (iv) section 743, (v) section 751, (vi) section 1001, (vii) section 1012, and (viii) section 1274. Thus, disguised sale treatment generally would have produced significantly different tax effects as opposed to the contribution-distribution scenario.

For example, a serial distribution of cash from a partnership generally permits the partner to recover its basis in its partnership interest before recognizing gain. Section 731. However, a deemed sale of such partnership interest for cash over the same time period will generate gain on the first dollars deemed paid to the selling partner. Section 1001. Even if the deemed sale of a partnership interest is treated as a tax-deferred installment sale under section 453, the selling partner will be required to recognize a portion of the overall gain each time it receives partial payment under the installment note, and the selling partner could owe an interest charge to the Service on the deferred portion of the tax liability. See section 453A(c).

Also, a distribution of cash or property from a partnership with (and, in some cases, without) a section 754 election in effect will trigger the basis adjustment rules of section 734(b). A deemed sale of partnership interest for cash or property with (and, in some cases, without) a section 754 election in effect will trigger the basis adjustment rules of section 743(b). A detailed description of the differences between the basis adjustment rules of section 734(b) and

section 743(b) is beyond the scope of this outline, but some differences should be highlighted. First, section 743(b) adjustments to the bases of partnership property are made only with respect to the transferee partner, while section 734(b) adjustments to the bases of partnership property are taken into account by all partners. Second, the method of determining the aggregate amount of a section 743(b) adjustment is based on a partnership liquidation model, and the method of determining the aggregate amount of a section 734(b) adjustment generally is based on the step-up or step-down of the basis of distributed property and the amount of gain or loss recognized on such distribution. Third, the mandatory basis adjustments under section 734(b) and section 743(b) (i.e., adjustments required even in the absence of a section 754 election) are triggered under different circumstances that are not economically equivalent. For example, a distribution of property that would trigger a mandatory basis adjustment under section 734(b) (e.g., the distributed property's basis in the hands of the distributee partner increases by more than $250,000 upon the distribution) may not trigger a mandatory basis adjustment under section 743(b) if recast as a deemed sale of a partnership interest (e.g., the property actually distributed (plus the partnership's other property) do not have an aggregate built-in loss in excess of $250,000). Fourth, the notification requirements for partnerships and partners differ between section 734(b) and section 743(b) with respect to who has an obligation to provide notification and who can rely upon such notification for tax return purposes.

To add more complication to these proposed interest regulations, significant differences exist between the application of the "hot asset" rules of section 751(b) with respect to distributions of property and the application of the "hot asset" rules of section 751(a) with respect to sales of partnership interests. A detailed discussion of section 751 is beyond the scope of this outline as well, but certain differences should be highlighted. First, partnership inventory

is treated differently under section 751. With respect to distributions of property, only inventory that is “substantially appreciated” is treated as a “hot asset.” Section 751(b). With respect to sales of partnership interests, all inventory is treated as a “hot asset.” Section 751(a). Second, the tax effects of the application of section 751 differ between a distribution and a sale. With respect to a sale of partnership interest, section 751(a) will affect only the selling partner’s tax treatment of such sale. With respect to a distribution of property, section 751(b) often will affect the tax consequences of not only the distributee partner but of all other partners as well. Third, the methods of determining how much of a distribution or how much of the proceeds from the sale of a partnership interest is subject to section 751 differ rather significantly.

A partnership’s distribution of property will not cause a deemed termination of such partnership under section 708(b)(1)(B). However, a sale of a partnership interest could cause such a termination if such interest (and all other interests sold or exchanged within a 12-month period) constituted 50 percent or more of the total interest in partnership capital and profits. Such a termination of a partnership is treated as a deemed contribution of all assets and liabilities to a new partnership followed by the liquidation of the transferor partnership. Although most adverse tax effects of a deemed termination of a partnership under section 708(b)(1)(B) have been eliminated, a few remain. Upon a deemed termination, depreciation restarts with respect to all depreciable property of the partnership. This means, for example, that, if a partnership terminates under section 708(b)(1)(B) in 2004, depreciable partnership property placed in service in 2000 that would have been depreciated over 7 years will now be depreciated effectively over 11 years (i.e., the first 4 years prior to the termination plus a new 7-year period as a result of the termination). Furthermore, the taxable year of the partnership ends on the date of the deemed termination. As a result, partners could be required to take into account more than

12 months of partnership income or loss in a single taxable year. Finally, the "new" partnership formed as a result of a deemed termination under section 708(b)(1)(B) is entitled to make new partnership-level elections, such as a section 754 election. Stated differently, a partnership that has a section 754 election in effect must make a new section 754 election after a deemed termination of the partnership in order to continue to apply sections 734 and 743 in all relevant cases. On the other hand, a deemed termination may be a helpful way to allow, absent consent from the Service, a partnership to cease applying sections 734 and 743 in all relevant cases.

From the perspective of the purchasing partner in the context of a disguised sale of a partnership interest, several differences exist between a contribution of consideration to a partnership in exchange for a partnership interest in a transaction to which section 721(a) applies and a transfer of consideration to another partner in exchange for a partnership interest in a transaction subject to sections 1001 and 1012. With respect to a transaction to which section 721(a) applies, a partner takes a substituted basis in its partnership interest equal to the basis of the property contributed to the partnership, and the partnership takes a carryover basis in the property contributed. Sections 722, 723. Furthermore, the built-in gain or loss in the contributed property cannot be shifted to another partner. Sections 704(c)(1)(A), (B), (C), 737. With respect to a deemed purchase of a partnership interest, a purchasing partner takes a cost basis in the acquired partnership interest, and, if noncash property is deemed to be transferred in exchange for such interest, the purchasing partner realizes and generally recognizes the built-in gain or loss in such property at the time of the disguised sale. Sections 1001, 1012. With respect to sections 734 and 743, a contribution of property in a transaction to which section 721(a) applies does not trigger either of these basis-adjustment provisions. However, a deemed purchase of a partnership interest may trigger section 743 if the partnership has a section 754 election in effect

or the mandatory basis adjustment provisions apply. If the property actually contributed to the partnership in the disguised sale transfers has built-in gain, the contributing/purchasing partner ordinarily will want the partnership to make a section 754 election so as to avoid temporarily duplicating the built-in gain in the property actually contributed to the partnership (since the contributing partner would have already recognized such gain on the deemed disguised purchase of its partnership interest with such property). However, if the property actually contributed to the partnership in the disguised sale transfers has built-in loss, the contributing/purchasing partner ordinarily will want the partnership not to make a section 754 election so as to temporarily duplicate the built-in loss in the property actually contributed to the partnership (since the contributing partner would have recognized already such loss presumably on the deemed disguised purchase of its partnership interest with such property).

b) Deemed Transactions Relating to Disguised Sale Treatment

The proposed interest regulations not only provided that certain transfers were treated as a disguised sale of a partnership interest for all purposes of the Code. They also outlined in detail the precise steps taxpayers were treated as taking with respect to a disguised sale for all purposes of the Code. Former Prop. Treas. Reg. § 1.707-7(a)(2). This aspect of the proposed interest regulations stood to create considerable complexity and administrative burdens.

(1) Timing of Deemed Transactions

Under the proposed interest regulations, a transfer of consideration was treated as occurring on the date of the actual transfer or, if earlier, on the date that the transferor agreed in

writing to make the transfer. Former Prop. Treas. Reg. § 1.707-7(a)(2)(ii)(A). This rule did not seem to create any problems. However, the proposed interest regulations also provided that the sale and the purchase of a selling partner's partnership interest were considered to take place on the date of the earliest of the transfers that constituted the disguised sale for all purposes of the Code. Id. As will be described below in more detail, this rule stood to create additional complexity and administrative burdens in applying other tax rules to the deemed sale.

(2) Amount of Partnership Interest Deemed Sold and Purchased

Under the proposed interest regulations, if a transfer of consideration by the partnership to a selling partner and a transfer of consideration by a purchasing partner to a partnership were treated as a sale under the regulations, the selling partner was treated as selling to the purchasing partner a partnership interest with a value equal to the lesser of the selling partner's consideration and the purchasing partner's consideration. Former Prop. Treas. Reg. § 1.707-7(a)(3). Simultaneous transfers of consideration by more than one purchasing partner to a partnership or by a partnership to more than one selling partner were aggregated. Id. In those cases, each purchasing partner was presumed to have purchased that fraction of each partnership interest sold equal to the amount of consideration transferred by that partner to the partnership over the aggregate consideration transferred by all purchasing partners to the partnership. Id. Further, each selling partner was presumed to have sold that fraction of the total partnership interests sold equal to the amount of consideration transferred by the partnership to that partner over the aggregate consideration transferred by the partnership to all selling partners. Id.

(3) Partnership Liability Relief Included in Amount Deemed Realized from Disguised Sale

Under the proposed interest regulations, the amount realized by a selling partner on the sale of the selling partner's partnership interest included any reduction in the selling partner's share of partnership liabilities that was treated as occurring as a result of the sale. Former Prop. Treas. Reg. § 1.707-7(a)(4). If a sale of a partnership interest and either a distribution by the partnership to the selling partner or a contribution by the purchasing partner to the partnership occurred on the same date that was not treated as part of the disguised sale, the reduction in the selling partner's share of partnership liabilities was computed immediately after the sale and before the distribution or contribution. Id.

(4) Deemed Disguised Sale Precedes Excess Distribution to Selling Partner

Under the proposed interest regulations, if a portion of a transfer of consideration by a partnership to a selling partner was not treated as part of a sale of the selling partner's partnership interest (i.e., the "excess distribution") and the sale was treated as occurring on the same date as the excess distribution, then the excess distribution was treated as occurring immediately following the sale. Former Prop. Treas. Reg. § 1.707-7(a)(5). This rule appeared to be a taxpayer friendly rule, at least from the perspective of the selling partner. If the excess distribution were taken into account prior to the sale, the distribution would have reduced the basis of the selling partner's partnership interest, thereby increasing gain or decreasing loss for the selling partner.

(5) Simultaneous Transfers of Same Consideration

Under the proposed interest regulations, if the transfer of consideration by the purchasing partner and the transfer of consideration to the selling partner were "simultaneous" and the consideration transferred was "the same," the partners and the partnership were treated as if, on the date of the sale, the purchasing partner transferred that partner's consideration directly to the selling partner in exchange for all or a portion of the selling partner's interest in the partnership. Former Prop. Treas. Reg. § 1.707-7(a)(2)(ii)(B).

The use of the word "simultaneous" appeared to mean that transfers occurring even one minute (even one second) apart would not have fallen into this rule (i.e., the only transfers falling into this rule presumably would be transfers that were treated as occurring at the exact same time by reason of the relevant closing documents regarding the transfers). Since transfers to and from partnerships occurring at the exact same time would appear to be rare, this rule seemed to have a very limited application. Query whether "simultaneous" should have been replaced with a concept that captured transfers to and from partnerships that occur in some short period of time, such as one month.

Further, what was meant by "the same" consideration in the context of transfers to and from a partnership of money? Query whether this meant that some sort of tracing requirement must have been met in order to fall into this rule as well. Query whether the taxpayer-friendly rules regarding sourcing debt proceeds under Temp. Treas. Reg. § 1.163-8T should have applied to avoid a tracing requirement. Query whether a transfer of one foreign currency and an economically equivalent transfer of another foreign currency (or of U.S. dollars) should have been considered "the same" property.

(6) Simultaneous Transfers of Different Consideration

Under the proposed interest regulations, if the transfer of consideration by the purchasing partner to the partnership and the transfer of consideration by the partnership to the selling partner were "simultaneous" and the consideration transferred was not "the same," the partners and the partnership were treated as if, on the date of the sale, the purchasing partner transferred that partner's consideration to the partnership in exchange for the consideration to be transferred to the selling partner (the "exchange transaction") and then the purchasing partner transferred the selling partner's consideration to the selling partner in exchange for all or a portion of the selling partner's partnership interest (the "sale transaction") (i.e., overall, the "exchange first recast"). Former Prop. Treas. Reg. § 1.707-7(a)(2)(ii)(B). Again, this rule presented the same issue as in the preceding rule regarding the use of the term "simultaneous." In addition, query why Treasury and the Service chose to treat the exchange transaction as occurring before the sale transaction. Note that the recast could have been treated as a sale of the selling partner's partnership interest in exchange for the purchasing partner's consideration that it actually transferred to the partnership followed by the selling partner exchanging the purchasing partner's consideration for the consideration that the selling partner actually received from the partnership (i.e., overall, the "sale first recast"). The preamble did not address why the exchange first recast was used rather than the sale first recast.

It appears that the tax results to the partners and the partnership under both recasts could have been advantageous or disadvantageous depending on several factors, such as the built-in gain or loss in each of the partnership assets and the built-in gain or loss in each of the partnership interests. However, it appears that the exchange first recast was preferable since it avoided adding even more complexity to the proposed interest regulations. Some of the

differences between the two recasts, which demonstrate the potential for additional complexity in the sale first recast, are outlined below.

In the exchange first recast, the initial exchange transaction ordinarily would not have caused the purchasing partner to recognize any built-in gain or loss in the consideration actually transferred to the partnership and the partnership to have recognized any built-in gain or loss in the consideration actually transferred to the selling partner pursuant to section 1001. The gain or loss recognized at the partnership level would have been taken into account by all persons who were partners at the time of the initial exchange transaction in accordance with section 704. This had two effects: (i) The selling partner's distributive share of the gain or loss would have adjusted the basis of the selling partner's partnership interest prior to its sale to the purchasing partner under section 705, thereby decreasing gain or loss on such subsequent sale; and (ii) the purchasing partner would not have taken any portion of such partnership-level gain or loss into account unless it was already a partner prior to the time of the disguised sale pursuant to section 706. Like the exchange first recast, the sale first recast ordinarily would have caused (i) the purchasing partner to have recognized any built-in gain or loss in the consideration actually transferred to the partnership (however, due to the sale transaction rather than the exchange transaction) and (ii) the partnership to have recognized any built-in gain or loss in the consideration actually transferred to the selling partner pursuant to section 1001. Unlike the exchange first recast, the partnership-level gain or loss from the exchange transaction, which occurred after the initial sale transaction, would not have affected the adjusted basis of the selling partner's partnership interest for purposes of determining gain or loss from the sale transaction, thereby potentially duplicating built-in gain or loss. Further, the initial sale transaction could have caused the partnership to terminate under section 708(b)(1)(A) (e.g., by reducing the

number of partners from two to one), which could have caused the subsequent exchange transaction to occur between the purchasing partner and the selling partner rather than the selling partner and the partnership (since the partnership would no longer exist). Further, the initial sale transaction in the sale first recast could have triggered basis adjustments to partnership property if a section 754 election was in effect (or, in certain cases, regardless of a section 754 election). These basis adjustments could have affected the amount of partnership-level gain or loss actually taken into account by the purchasing partner upon the subsequent exchange transaction. Finally, the partnership-level gain or loss from the exchange would not have been taken into account by the selling partner to the extent that the initial sale transaction reduced its interest in the partnership.

(7) Nonsimultaneous Transfers

The actual legislative text of section 707(a)(2)(B) does not address whether the relevant two transfers must be simultaneous or must occur within a particular time period to be considered a disguised sale. With respect to disguised sales of property, the legislative history of section 707(a)(2)(B) cites one case, Otey, which involved nonsimultaneous transfers. Thus, it seems reasonable that the property regulations apply to nonsimultaneous transfers as well. However, with respect to disguised sales of partnership interests, the legislative history of section 707(a)(2)(B) cites only case law involving purported simultaneous transfers of consideration (i.e., CSC and Jupiter). Thus, the case does not appear to be as strong to have drafted the proposed interest regulations so that they applied to nonsimultaneous transfers. Although, it does appear that there was enough in the legislative history to justify extending the regulations to nonsimultaneous transfers. See S. Rep. No. 98-169 at 231 (1984) ("These regulations may

provide for a period, such as three years, during which contributions by and distributions to the same <u>or another partner</u> normally will be presumed related.”). Unfortunately, extending the regulations to such transfers injected even more complexity and administrative burden into an already complex and administratively burdensome area of tax law. The proposed rules regarding nonsimultaneous transfers that follow demonstrate this problem.

(a) <u>Transfer to Selling Partner First</u>

Under the proposed interest regulations, if the transfer by the partnership to the selling partner occurred before the transfer of consideration by the purchasing partner to the partnership, the partners and the partnership were treated as if, on the date of the sale (i.e., the date of the earliest transfer), (i) the purchasing partner transferred an obligation to deliver the purchasing partner’s consideration to the partnership in exchange for the selling partner’s consideration (the “obligation exchange”) and (ii) then the purchasing partner transferred the selling partner’s consideration to the selling partner in exchange for all or a portion of the selling partner’s interest in the partnership (the “sale transaction”). Former Prop. Treas. Reg. § 1.707-7(a)(2)(C). Subsequently, on the date of the actual transfer of the purchasing partner’s consideration to the partnership, the purchasing partner and the partnership were treated as if the purchasing partner satisfied its obligation to deliver the purchasing partner’s consideration to the partnership (the “satisfaction transaction”). <u>Id.</u>

(b) <u>Transfer by Purchasing Partner First</u>

Under the proposed interest regulations, if the transfer of consideration by the partnership occurred after the transfer of consideration by the purchasing partner to the

partnership, the partners and the partnership were treated as if, on the date of the sale (i.e., the date of the earliest transfer), (i) the purchasing partner transferred the purchasing partner's consideration to the partnership in exchange for an obligation of the partnership to deliver the selling partner's consideration (the "obligation exchange") and (ii) then the purchasing partner transferred that obligation to the selling partner in exchange for all or a portion of the selling partner's interest in the partnership (the "sale transaction"). Former Prop. Treas. Reg. § 1.707-7(a)(2)(ii)(D). Subsequently, on the date of the actual transfer of the selling partner's consideration to the selling partner, the selling partner and the partnership were treated as if the partnership satisfied its obligation to deliver the selling partner's consideration to the selling partner (the "satisfaction transaction"). Id.

(c) Problems with Recasts for Nonsimultaneous Transfers

The combination of the two-year presumption in favor of disguised sales, the rule that treated the disguised sale as occurring on the date of the earliest of the transfers, and the recasts for nonsimultaneous transfers created the greatest risk that taxpayers would have stumbled unknowingly into a substantive and administrative disguised sale nightmare.

The following example demonstrates this potential nightmare (see diagram below). S and X are 80:20 domestic members of a domestic limited liability company treated as a partnership for Federal tax purposes, PS, formed in 2003. S's partnership interest has a value of $800 and a basis of $40. S has a capital account at the beginning of 2004 of $600. X's partnership interest has a value of $200 and a basis of $20. PS owns depreciable property worth $2,000 with a basis of $1,000. The property is not section 704(c) property. PS also has one

nonrecourse partnership liability of $1,000 with respect to which P, an unrelated foreign party, is the lender. PS's taxable year is the calendar year, and it has made a valid section 754 election.

Suppose that PS makes a $600 nonliquidating ordinary distribution of a portion of the depreciable property with a $50 basis to S in December 2004 (without transferring any portion of the liability). In 2005, PS exchanges the remaining portion of the depreciable property with an unrelated party, Q, for $900 of property in a taxable exchange. Later in November 2006, P contributes other property with a value of $600 and a basis of $500 to PS in exchange for an interest in PS. The partnership performs a section 704(b) partnership revaluation immediately before P's contribution in order to preserve S and X's 80:20 shares of the built-in gain in the depreciable property. Assume that the two-year presumption in favor of a disguised sale is not rebutted and no disguised sale exception applies.

Under the proposed interest regulations, P was treated as purchasing its partnership interest from S in December 2004 rather than receiving it in an exchange with PS in November 2006. Thus, P was treated as a partner in PS for all purposes of the Code 22 months before P and PS thought P was a partner.

Before P made its contribution to PS in November 2006, PS presumably would have issued Form K-1s to S and X for 2004 and 2005, which S and X would have used to file their relevant Federal tax returns for 2004 and 2005. Those Form K-1s presumably would have allocated 80 percent of all tax items to P along with 80 percent of the nonrecourse partnership liability. Note that the $600 distribution of the depreciable property presumably would have triggered a $10 increase to the basis of the remaining portion of the depreciable property in the hands of the partnership under sections 734(b) and 755, which would have reduced the amount

of gain on the subsequent sale of such remaining property to Q in 2005 (reflected in the Form K-1s for 2005).

If P was treated as purchasing 75 percent (i.e., $600/$800) of S's partnership interest in December 2004 under the proposed interest regulations, several issues would have arisen.

First, the basis and capital account effects of the distribution to S and the contribution by P would have been ignored for all purposes of the Code. The section 704(b) partnership revaluation would have been nullified as well. Note that a substitute section 704(b) partnership revaluation would not be available since a sale of a partnership interest is not an event that permits a section 704(b) revaluation.

Second, new basis and capital account effects from the disguised sale would have been taken into account from November 2004 to the present reporting year. For example, P would have been entitled to take into account 60 percent of all PS tax items, and S would have been entitled to take into account only 20 percent of all PS tax items. P also would have stepped into the shoes of 75 percent of S's capital account in December 2004 rather than acquiring a $600 capital account upon its actual $600 contribution to PS in November 2006.

Third, the section 734(b) adjustment would have been removed and replaced with a section 743(b) adjustment with respect to the disguised sale of 75 percent of S's partnership interest. Note that a section 743(b) adjustment would affect the bases of partnership assets only with respect to the acquiring partner rather than with respect to all partners pursuant to a section 734(b) adjustment.

Fourth, the disguised sale of 75 percent of S's partnership interest would have amounted to a disguised sale of a 60 percent interest in the total capital and profits interests in

PS. Thus, PS would have terminated under section 708(b)(1)(B) in December 2004. Such termination would have created two short taxable years in 2004 for PS and would have restarted the depreciation clock for the depreciable property, thereby affecting the property's adjusted basis and the amount of the resulting tax items of PS available to be allocated to the partners in 2004 and future years.

Fifth, rather than PS and S applying the "hot asset" rules of section 751(b) applicable to distributions, S would have applied the "hot asset" rules of section 751(a). Note that the "hot asset" rules of section 751(b) applicable to distributions can affect all partners, and the "hot asset" rules of section 751(a) applicable to sales and exchanges affect only the transferring partner.

Sixth, treating P as a partner in November 2004 would have caused the nonrecourse liability to be treated in November 2004 as a partner nonrecourse liability allocated wholly to P. This conversion of the character of the liability in 2004 rather than in 2006 would have accelerated the deemed distributions of cash to S and X from 2006 to 2004, which could have triggered gain to S and X under section 731.

Seventh, since P is a foreign person and would have been treated as a partner since November 2004, PS presumably would have had an obligation to withhold with respect to P's distributive share of PS income, which PS, of course, did not satisfy. Thus, PS would have been liable for withholding and presumably interest and penalties with respect to the failure to withhold in 2004 and 2005.

Eighth, since the relevant transfers were not simultaneous and the transfer to S occurred first, the proposed interest regulations would have treated the parties as performing the following steps for all purposes of the Code. P transferred in December 2004 an obligation to PS

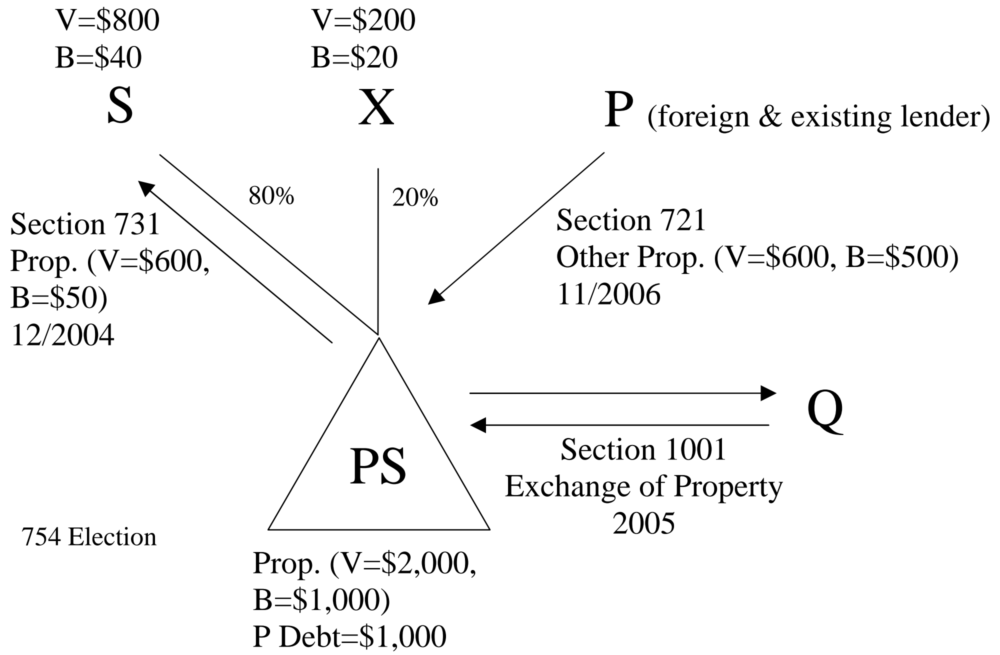
to deliver the property it actually contributed to PS in November 2006 in exchange for the portion of the depreciable property actually distributed to S in December 2004. This exchange presumably would have caused PS to recognize all the built-in gain in the portion of the depreciable property actually distributed to S, which would have affected all the partners' capital accounts and bases in their partnership interests. Continuing with the recast under the proposed interest regulations, immediately after the exchange, P purchased 75 percent of S's interest in PS in exchange for the portion of the depreciable property actually distributed to S, thereby causing S to recognize all of the built-in gain in that portion of its partnership interest. Finally, in November 2006, P satisfied its obligation to PS by delivering the property it actually contributed to PS. With respect to the deemed obligation between P and PS, P presumably would have imputed interest income, and PS would have imputed interest expense for 2004, 2005, and 2006, which would have affected all the partners' capital accounts and bases in their partnership interests.

Ninth, all of the preceding changes would have caused PS to file amended partnership returns, to issue amended Form K-1s to S and X from 2004 to the current reporting year, and to issue for the first time Form K-1s to P for 2004 and 2005. The changes to the Form K-1s would have caused S, X, and P to file amended Federal tax returns as well, thereby extending the statute of limitations for issues related to those tax returns.

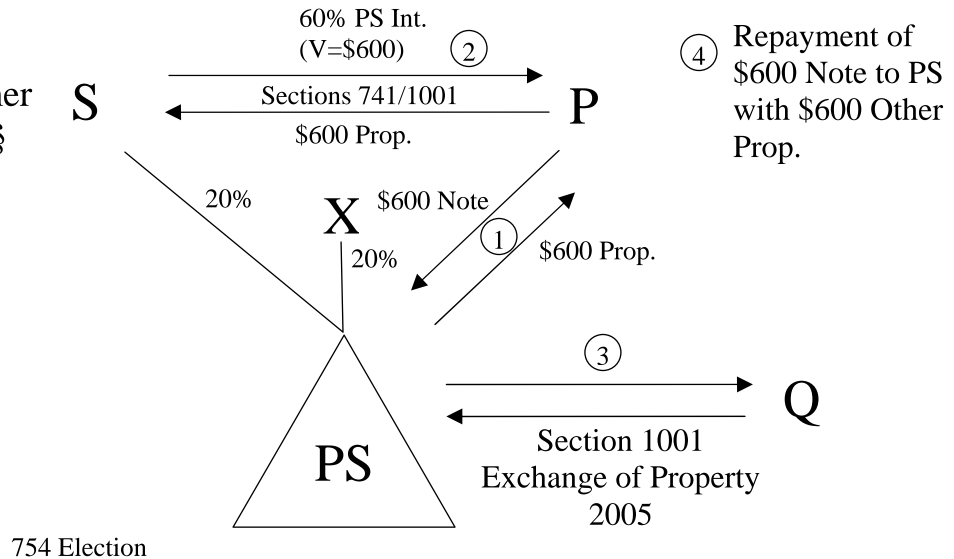
What a disaster!

Example

Actual Transactions



Recast under Former Prop. Treas. Reg. § 1.707-7



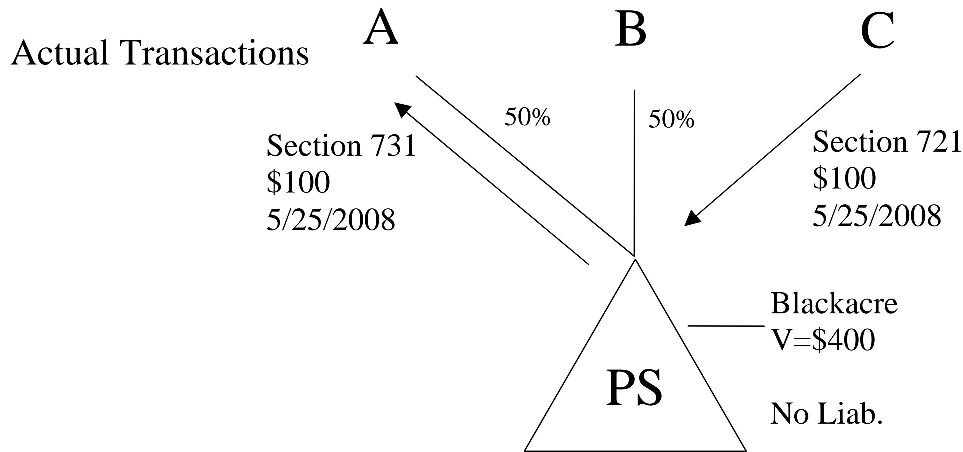
Steps 1 & 2 occur in 12/2004.
Step 3 occurs in 2005.
Step 4 occurs in 11/2006.

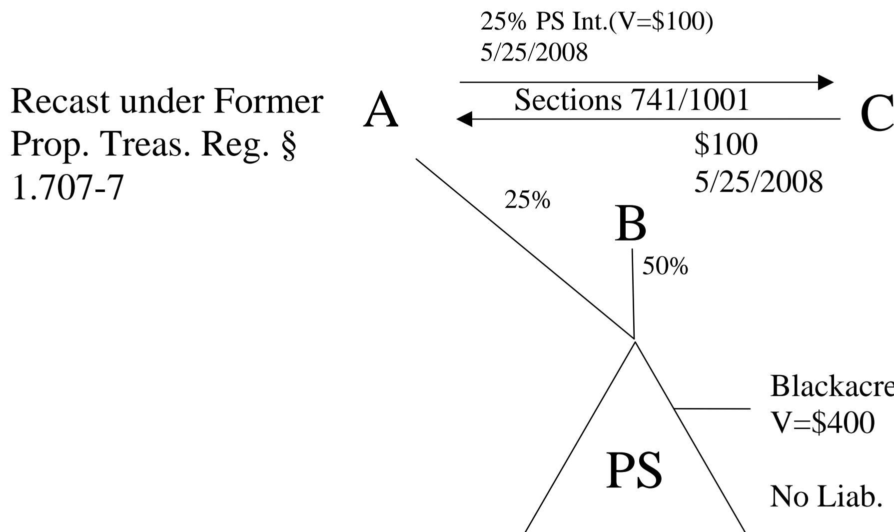
6. Effective Date

Former Prop. Treas. Reg. § 1.707-9 generally provided that the rules in the proposed interest regulations would have applied to any transaction with respect to which all transfers that were part of a sale of a partnership interest occurred on or after the date the proposed interest regulations were published as final Treasury regulations. Former Prop. Treas. Reg. § 1.707-9(a)(2) also provided that, in case of any transaction with respect to which one or more of the transfers occurred on or before April 24, 1991, the determination of whether the transaction was a disguised sale of a partnership interest under section 707(a)(2)(B) was made on the basis of section 707(a)(2)(B) and the guidance provided in the legislative history of that statute. Former Prop. Treas. Reg. § 1.707-9(a)(2) extended this rule to any transaction with respect to which one or more transfers occurred after April 24, 1991, but before the date the proposed interest regulations would have been published as final Treasury regulations.

7. Additional Illustrative Examples

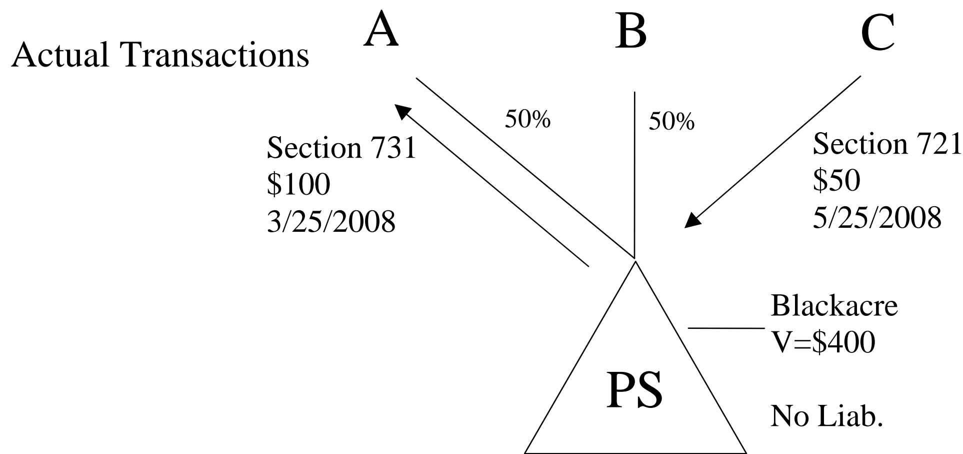
Example 1: Simultaneous Cash Transfers

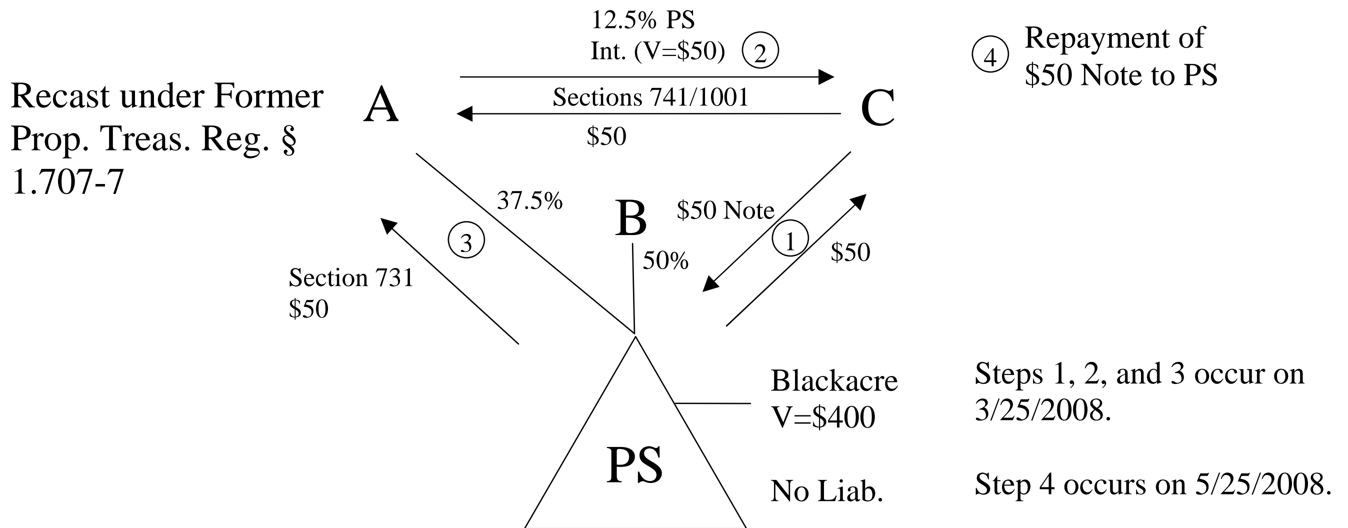




Note: Assume that there are no facts and circumstances that prevent the two-year presumption in favor of a disguised sale from applying. Also assume that there are no facts and circumstances that trigger one of the exceptions from disguised sale treatment. See Former Prop. Treas. Reg. § 1.707-7(l) ex. 1.

Example 2: Nonsimultaneous and Unequal Cash Transfers



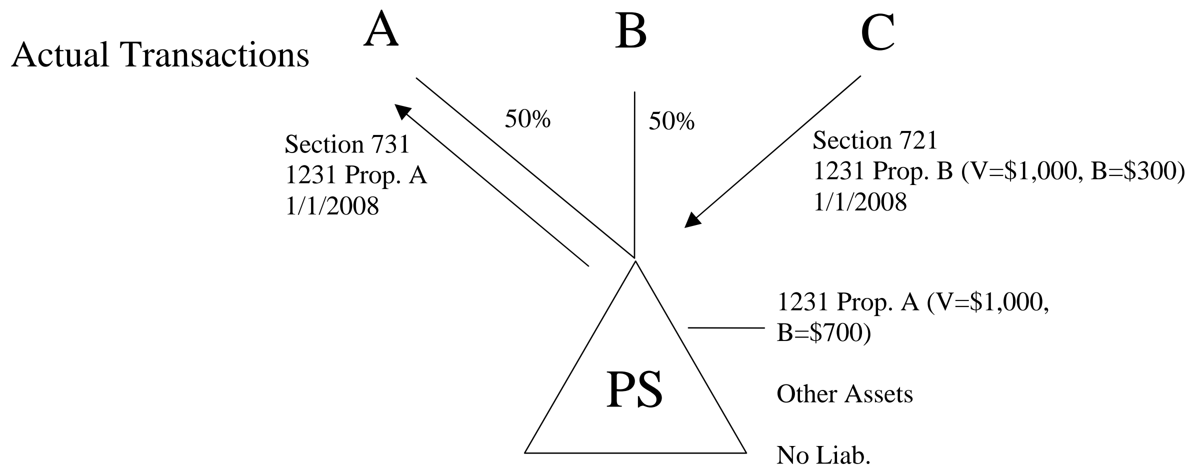


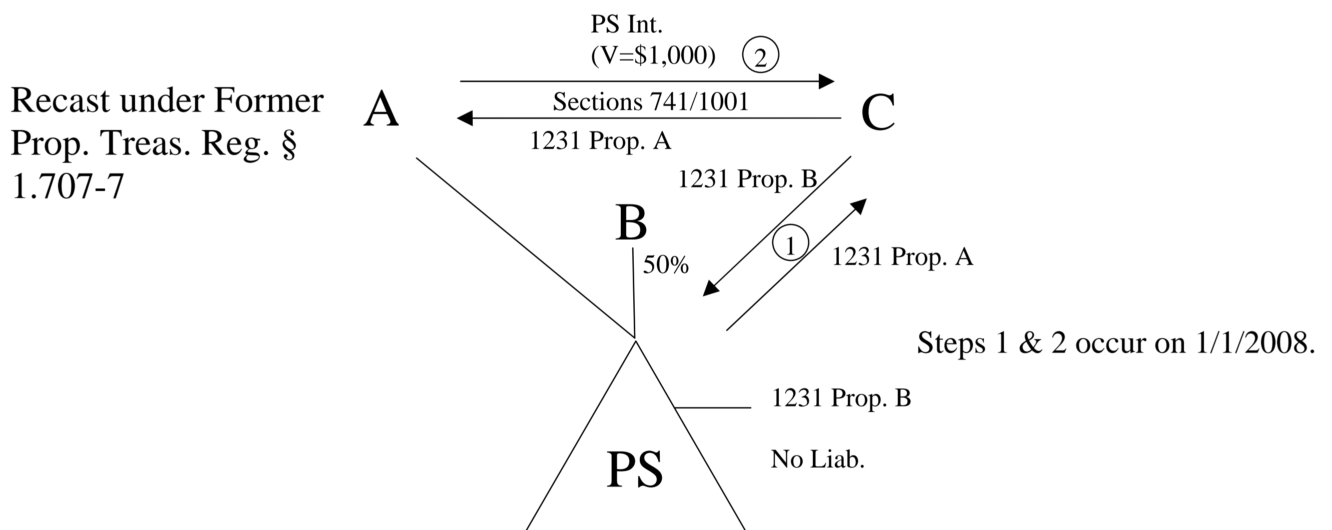
<u>Note</u>: The same assumptions apply as in Example 1. <u>See</u> Former Prop. Treas. Reg. § 1.707-7(l) <u>ex</u>. 2.

<u>Note</u>: If C's contribution occurred on January 1, 2010, steps 1, 2, and 3 still would be treated as occurring on March 25, 2008. Thus, C would be treated as a partner almost two years before C contributes anything to PS! <u>See also</u> Former Prop. Treas. Reg. § 1.707-7(l) <u>ex</u>. 5. Query whether the administrative burdens and technical issues created by treating such transactions as a

disguised sale outweighed the purported benefits. Query whether the two-year presumption in favor of a disguised sale should have applied in situations where the purchasing partner's transfer to PS occurred in a partnership taxable year later than the partnership taxable year in which PS's transfer to the selling partner occurred (i.e., situations in which a partner may be treated (e.g., seven years later on audit) as a partner one or two years before it made any contribution to the partnership).

Example 3: Simultaneous Transfers of Different Property



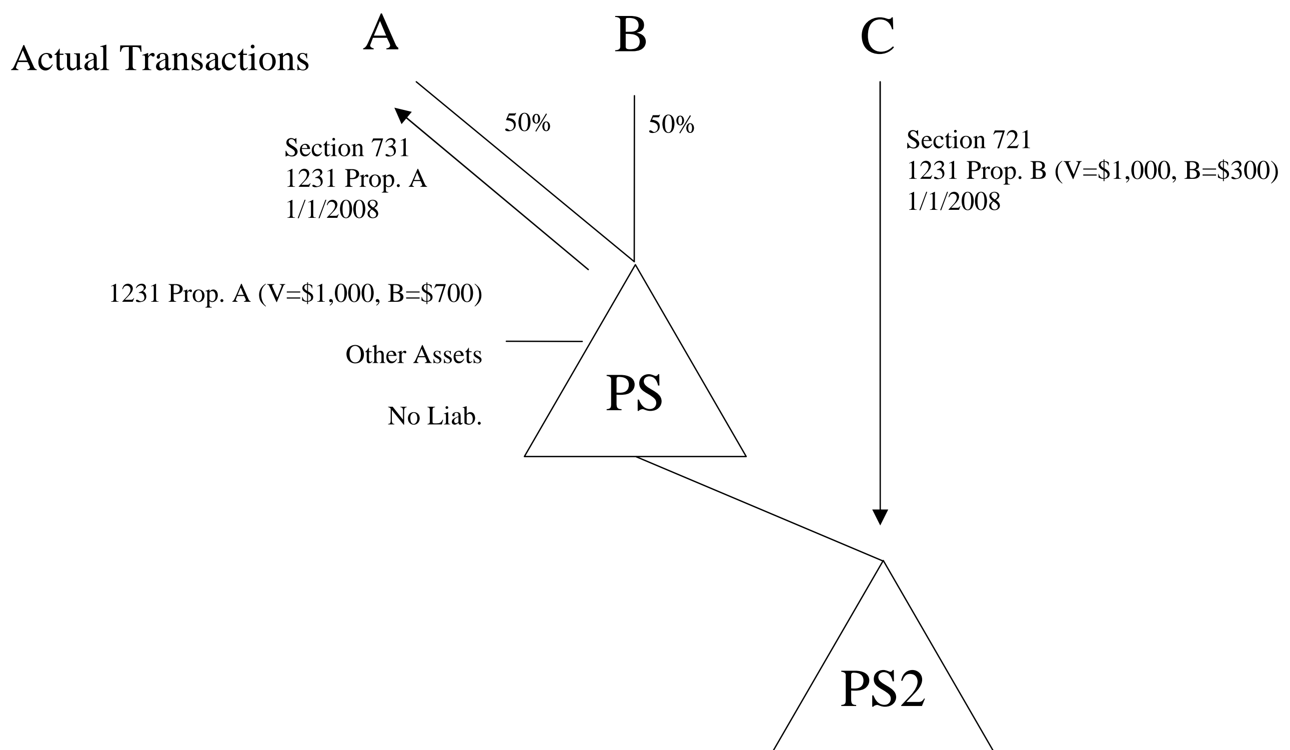


Note: The same assumptions apply as in Example 1. See Former Prop. Treas. Reg. § 1.707-7(l) ex. 3.

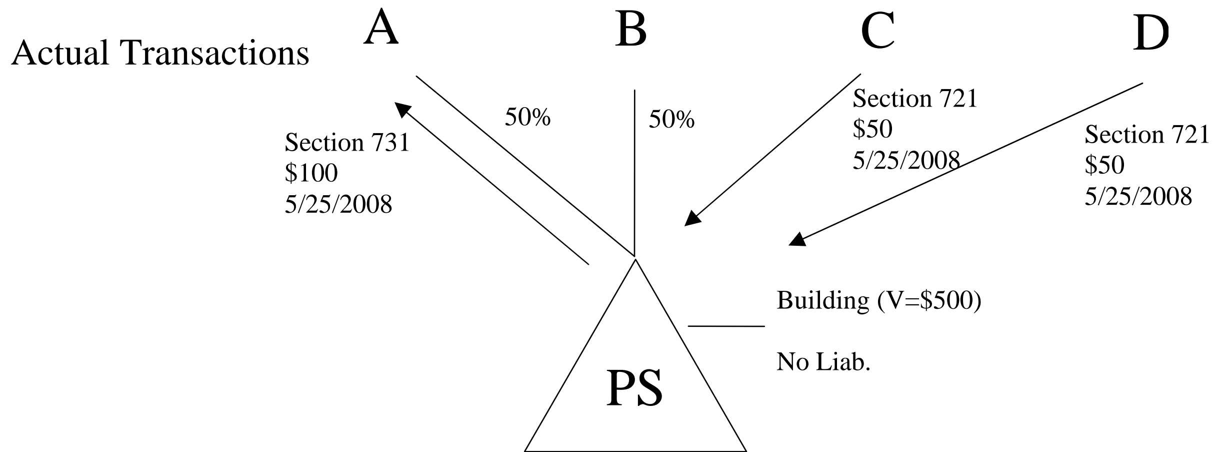
Note: It appears unlikely that the exchange of section 1231 properties would constitute a tax-deferred like-kind exchange under section 1031, since C would be treated as holding section 1231 Property A only for a moment. See section 1031(a)(1). Thus, this recast causes all partners to take into account some amount of recognized gain (including B).

Note: Query whether the two-year presumption in favor of disguised sale treatment should have applied in situations where the purchasing partner transfers cash or property and the selling partner receives something other than such cash or property from the partnership. Query further whether the two-year presumption in favor of disguised sale treatment should have applied in situations where the purchasing partner transfers a non-cash equivalent property and the selling partner receives a different non-cash equivalent property from the partnership. It appears that the disguised sale case law has not addressed this type of transaction yet. Finally, query whether the position that the two-year presumption in favor of disguised sale treatment should not have applied to these types of transactions is strengthened when considering a similar transaction that contains nonsimultaneous transfers.

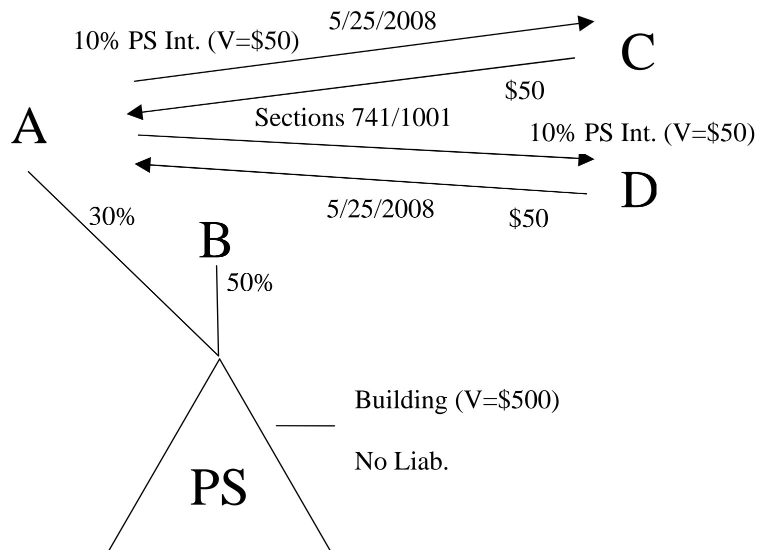
Note: The following structure might prevent the application of the two-year presumption in favor of a disguised sale. However, substance over form principles might cause PS2 to be disregarded as separate from PS.



Example 4: Multiple Simultaneous Transfers of Cash

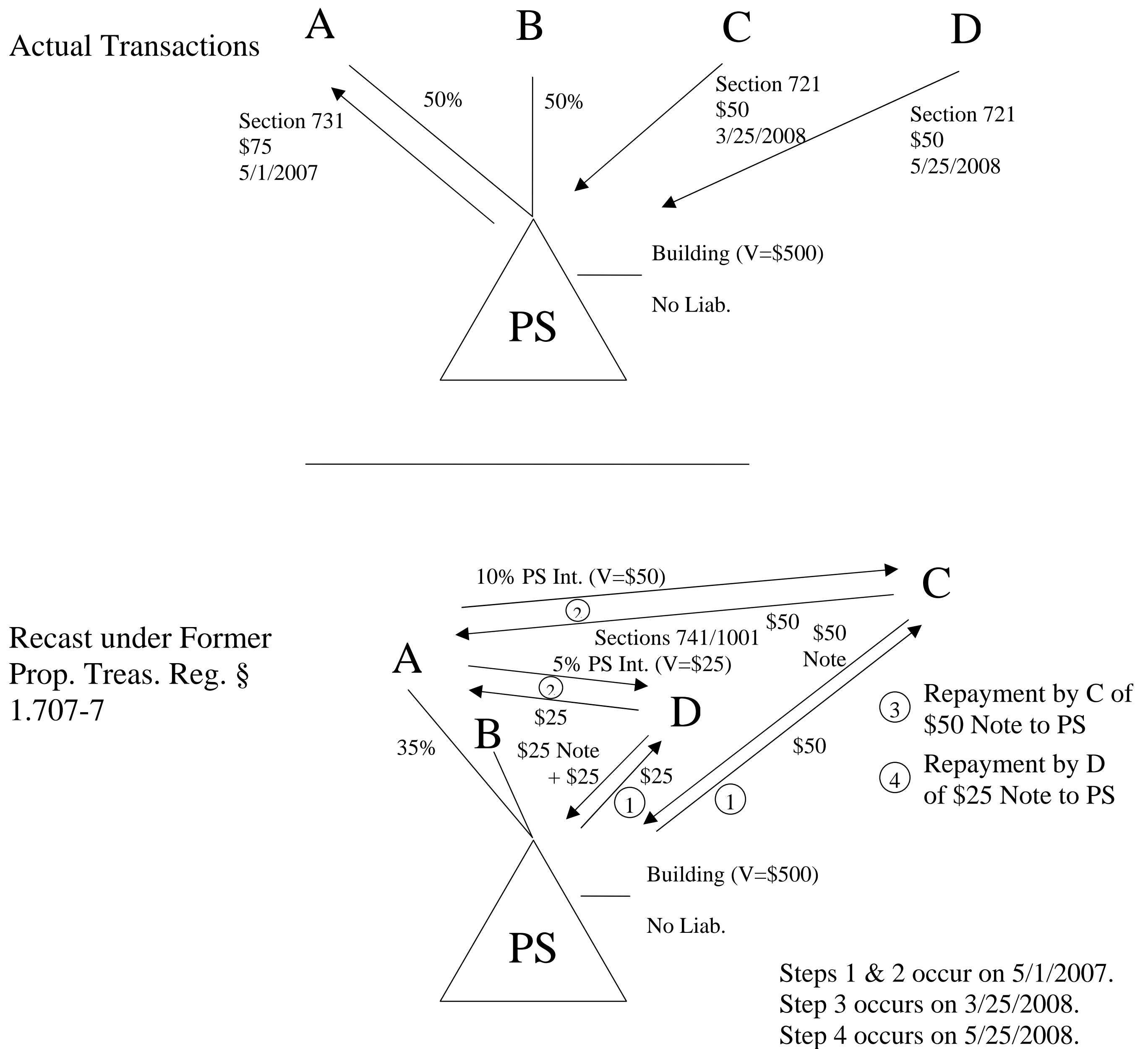


Recast under Former Prop. Treas. Reg. § 1.707-7



Note: The same assumptions apply as in Example 1. See Former Prop. Treas. Reg. § 1.707-7(l) ex. 4.

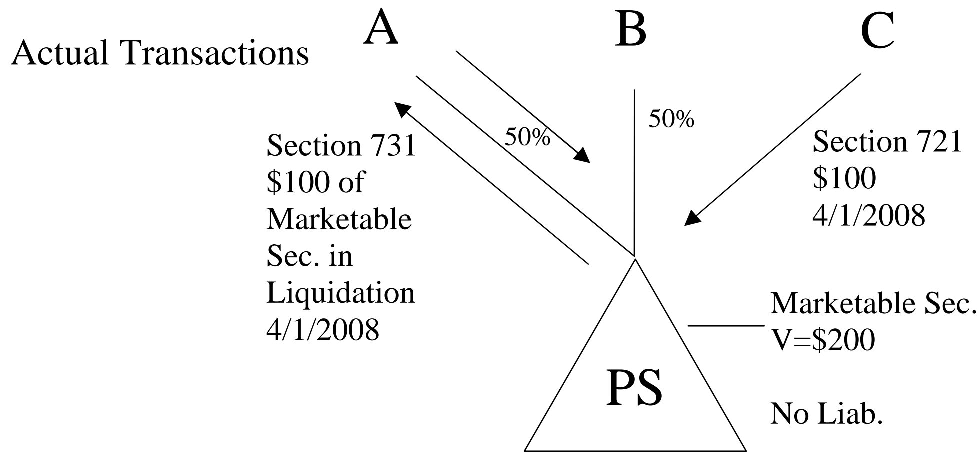
Example 5: Multiple Nonsimultaneous and Unequal Transfers of Cash



Note: The same assumptions apply as in Example 1. See Former Prop. Treas. Reg. § 1.707-7(l) ex. 5. Since the transfers made by C and D are not simultaneous, they are not aggregated for purposes of determining which partner receives which portion of the aggregate $75 interest in PS from A. Instead, the transfers are considered in the order in which they were made. See Former Prop. Treas. Reg. § 1.707-7(a)(2)(ii)(A). Query whether the rule regarding simultaneous transfers (as illustrated in Former Prop. Treas. Reg. § 1.707-7(l) ex. 4) should have been extended to all transfers occurring within the same taxable year of the partnership. There

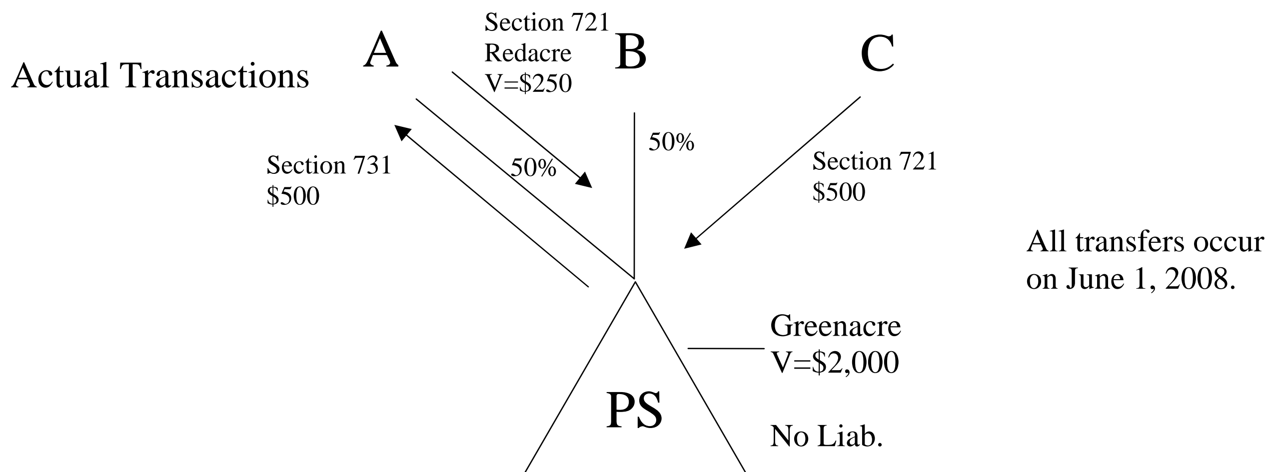
appears to be no policy reason not to have applied such a rule. If that rule applied in this case, C and D would be treated as purchasing equal portions of the aggregate $75 interest in PS from A.

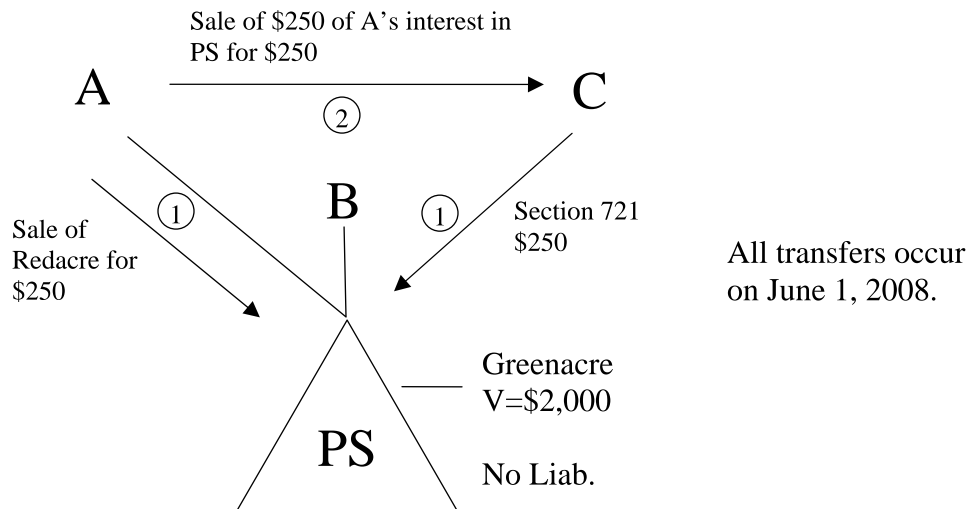
Example 6: Cash Liquidation



Note: Since the transfers occurred within two years, they would have been presumed to constitute a disguised sale of A's interest in PS to C. Former Prop. Treas. Reg. § 1.707-7(c). However, as long as the marketable securities are treated as money under section 731(c), the transfer from PS to A would not have been presumed to be part of a disguised sale of A's interest in PS since the transfer constitutes a distribution in liquidation of A's interest in PS with money, unless the facts and circumstances clearly establish otherwise. Former Prop. Treas. Reg. § 1.707-7(e), (l) ex. 6. The definition of a marketable security under section 731(c) is rather broad (e.g., it would include stock in a wholly owned corporate subsidiary of PS 90 percent of the assets of which consisted of money, marketable securities, or both). See, e.g., Treas. Reg. § 1.731-2(c)(3). However, if, for example, A had originally contributed the marketable securities to PS, such securities generally would not be treated as money under section 731(c), and, accordingly, the transfers would have been presumed to constitute a disguised sale of A's interest in PS to C. See section 731(c)(3)(A)(i). Note also that the concept of a distribution in liquidation of a partner's interest in a partnership includes serial distributions during a year or over several years. Treas. Reg. § 1.761-1(d).

Example 7: Disguised Sales of Property and Partnership Interest

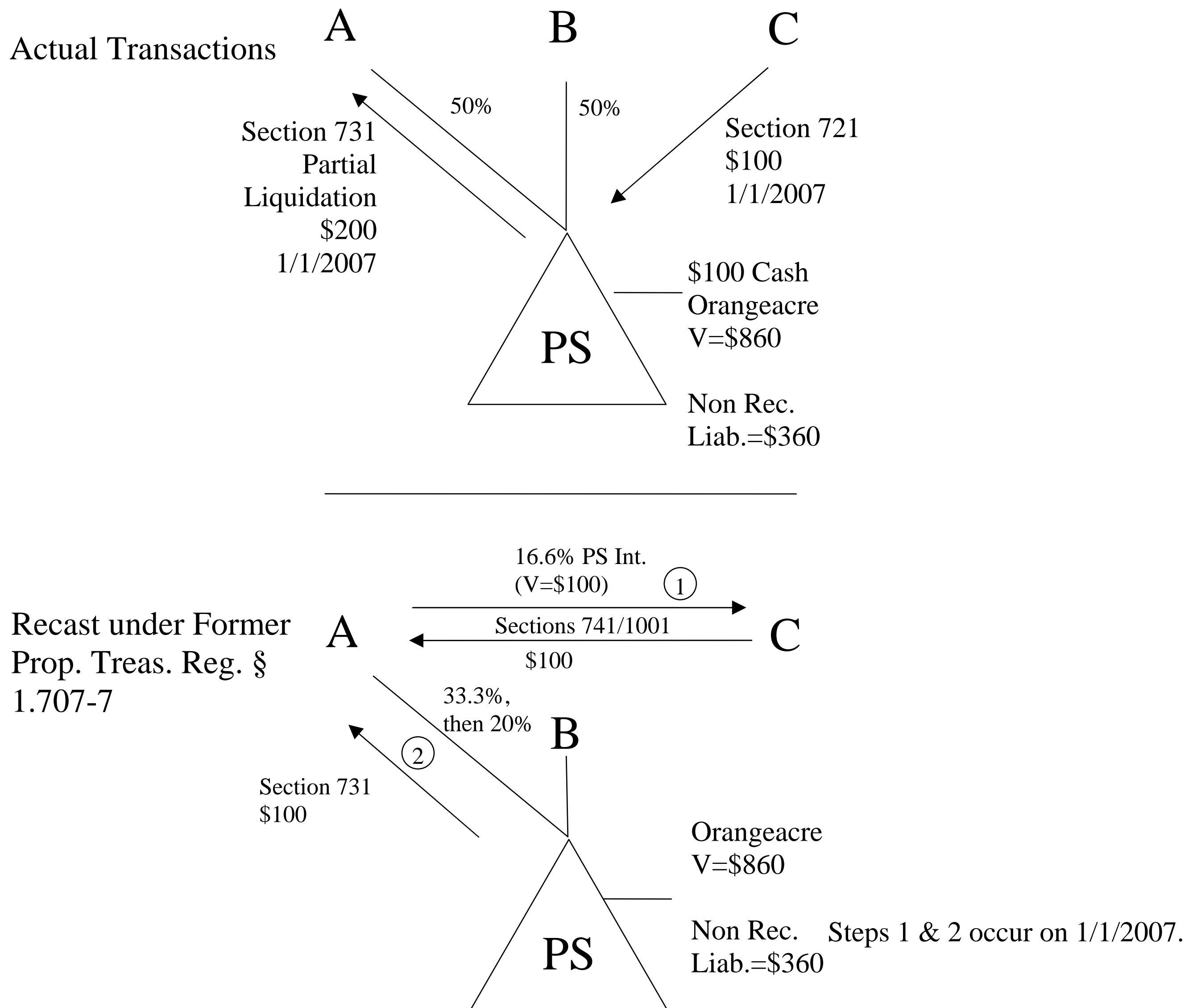




<u>Note</u>: The same assumptions apply as in Example 1. <u>See</u> Former Prop. Treas. Reg. § 1.707-7(l) <u>ex</u>. 7. If one of two transfers that otherwise would form part of a disguised sale of a partnership interest also would form part of a disguised sale of property, that transfer was treated as part of a disguised sale of property first and, to the extent any portion of that transfer was not considered part of the disguised sale of property, such portion was treated as part of the disguised sale of a partnership interest second. Former Prop. Treas. Reg. § 1.707-7(a)(6). Furthermore, it appears that the two-year presumption in favor of a disguised sale of property would have overridden the

same presumption in favor of a disguised sale of a partnership interest to the extent of any overlap, as well as the disclosure provisions regarding disguised sales of property, regardless of whether there actually was a disguised sale of property. Id.

Example 8: Disguised Sale of Partnership Interest with Nonrecourse Liabilities



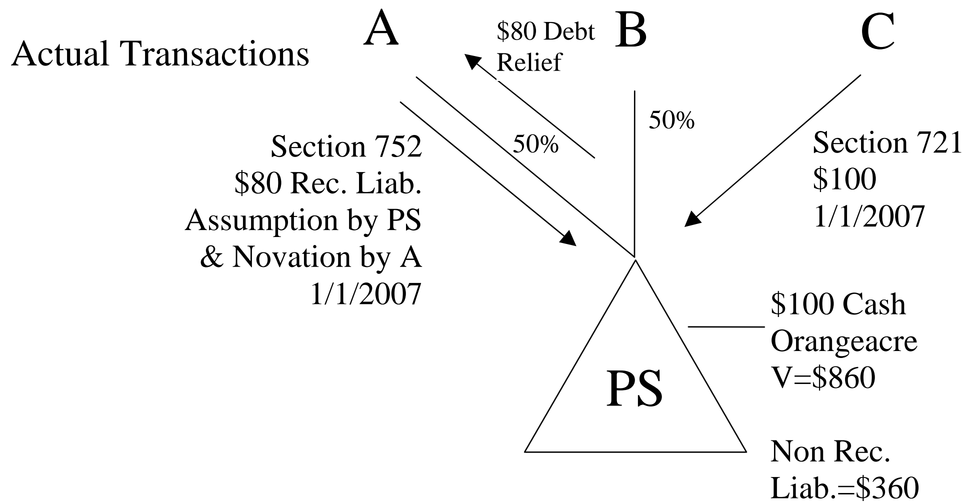
*C's deemed transfer of cash due to sharing Non Rec. Liab. and A's deemed receipt of cash due to sharing less Non Rec. Liab. under section 752 are disregarded in determining the amount of A's interest sold to C.

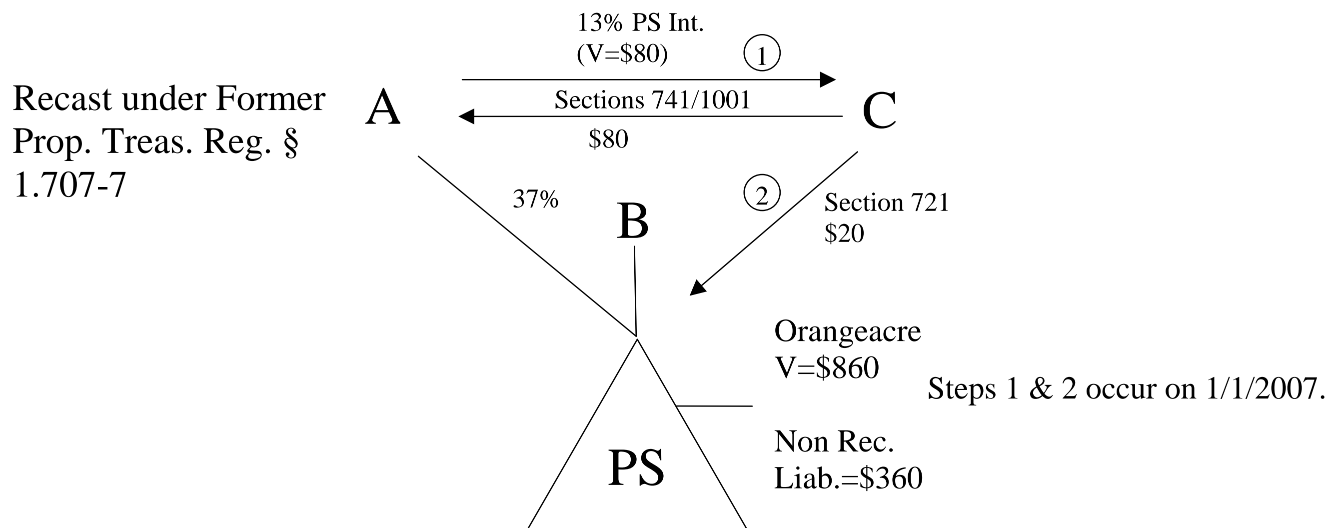
*However, A's debt relief from the disguised sale (but not from the subsequent cash distribution) is included in its amount realized from the disguised sale (amt. real.=$160=$100+($180-$120)).

Note: The same assumptions apply as in Example 1. See Former Prop. Treas. Reg. § 1.707-7(j)(1), (l) ex. 8. In determining the amount realized from the disguised sale, if the amount of A's debt relief were to be calculated after the subsequent $100 partial liquidating distribution, A's amount realized would increase, which would increase the amount of gain recognized from the disguised sale on a dollar for dollar basis. Thus, disregarding the debt relief from the

subsequent distribution is beneficial to A, particularly if A has sufficient basis in its remaining interest in PS to absorb the $100 distribution without realizing gain under section 731. Former Prop. Treas. Reg. § 1.707-7(a)(4).

Example 9: Disguised Sale of Partnership Interest Due to Assumption of Partner Liability



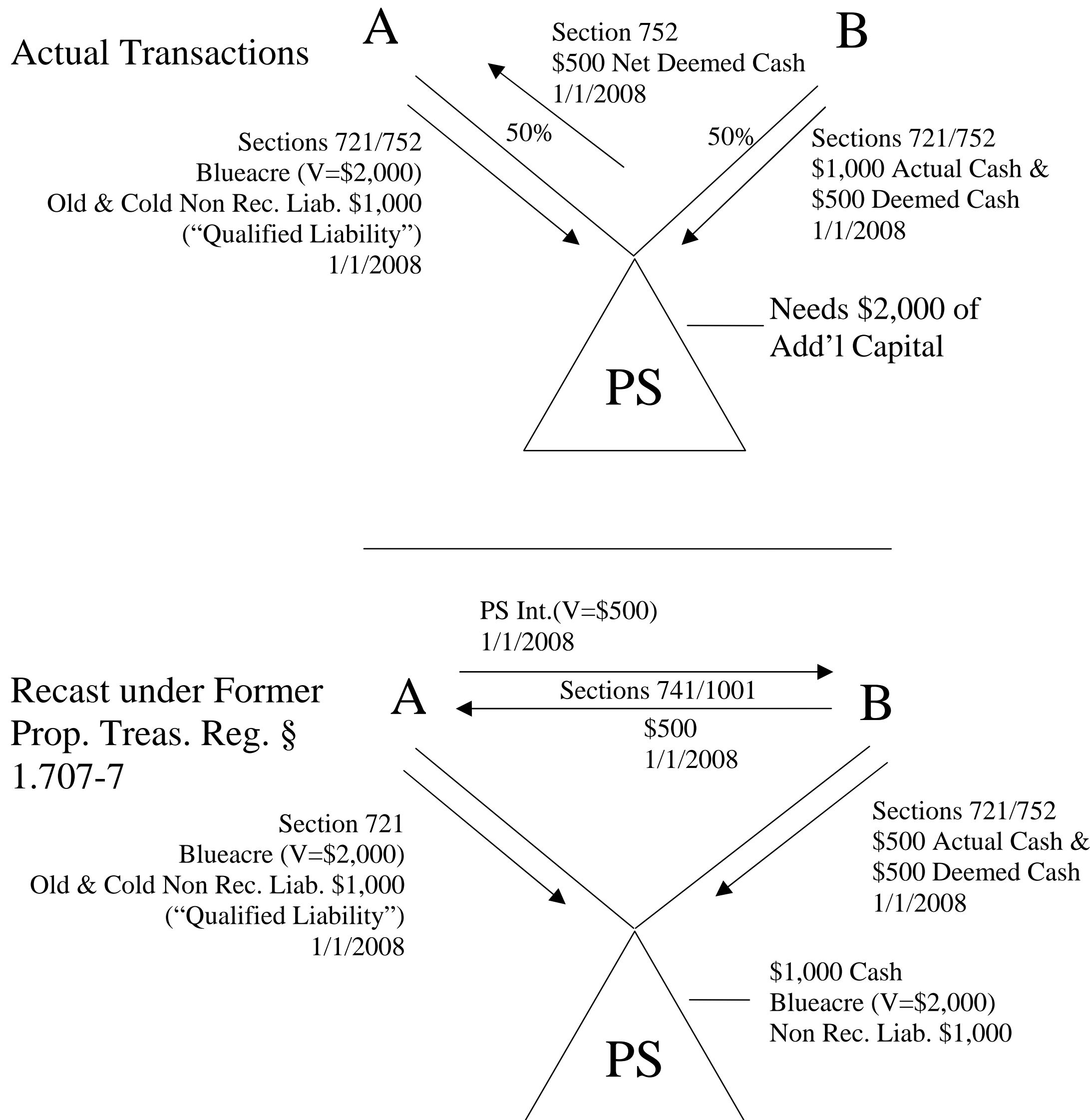


*C's deemed transfer of cash due to sharing Non Rec. Liab. & Rec. Liab. and A's deemed receipt of cash due to sharing less Non Rec. Liab. under section 752 are disregarded in determining the amount of A's interest sold to C (but A's deemed receipt of cash due to assumption of A's Rec. Liab. taken into account).

*However, A's Non Rec. Liab. debt relief from the disguised sale is included in its amount realized from the disguised sale (amt. real.=$127=$80+($180-$133)). A's Rec. Liab. debt relief is excluded to avoid double counting.

Note: The same assumptions apply as in Example 1. See Former Prop. Treas. Reg. § 1.707-7(a)(4), (j)(2), (l) ex. 9.

Example 10: No "Qualified Liability" Exception



Note: The same assumptions apply as in Example 1. There is no disguised sale of any portion of Blueacre to PS since A's $500 debt relief is attributable to a "qualified liability" under Treas. Reg. § 1.707-5(a)(6). Treas. Reg. § 1.707-5(a)(5). However, there was no comparable rule in the proposed interest regulations. Thus, although A and B merely are contributing equal amounts of value in order to satisfy PS's need for additional capital, A's deemed receipt of $500 pursuant to section 752 would have been considered with B's actual contribution of $1,000 as a disguised sale of a $500 portion of A's interest in PS. Former Prop. Treas. Reg. § 1.707-7(j)(2). There appears to be no policy reason to take into account debt relief from "qualified liabilities" in the context of disguised sales of partnership interests, particularly in light of the fact that such debt relief generally is disregarded in the context of disguised sales of property.

VII. Disclosure Rules for Disguised Sales

The disclosure rules for disguised sales of property generally have not been considered onerous, particularly since disclosure is only required when the relevant transfers occur within a two-year period. However, the proposed interest regulations would have expanded these disclosure rules in a dramatic way for disguised sales of partnership interests as well as disguised sales of property. These disclosure requirements were regarded as administratively burdensome and contributed to the decision by the Service and the Treasury to withdraw the proposed interest regulations.

A. Current Disclosure Rules for Disguised Sales of Property

There are three sets of circumstances in which disclosure is required under the property regulations.

First, under Treas. Reg. § 1.707-3(c)(2), disclosure in accordance with Treas. Reg. § 1.707-8 is required if (i) a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner within a two-year period (without regard to the order), (ii) the partner treats the transfers other than as a disguised sale of property for tax purposes, and (iii) the transfer of money or other consideration to the partner is not presumed to be a guaranteed payment for capital under Treas. Reg. § 1.707-4(a)(ii), is not a reasonable preferred return under Treas. Reg. § 1.707-4(a)(3), and is not an operating cash flow distribution under Treas. Reg. § 1.707-4(b)(2).

Second, disclosure under Treas. Reg. § 1.707-8 also is required if a partner treats a liability assumed or taken subject to by a partnership as a qualified liability even though such

liability was incurred within the two-year period prior to the date the partner transferred property to the partnership that had been encumbered by such liability. Treas. Reg. 1.707-5(a)(7)(ii).

Third, there are analogous disclosure rules for disguised sales of property from a partnership to a partner. Treas. Reg. § 1.707-6(c).

The disclosure required under Treas. Reg. § 1.707-8 is to be made on a completed Form 8275 or on a statement attached to the return of the transferor of property for the taxable year of the transfer. Treas. Reg. § 1.707-8(b). The disclosures must include the following: (i) A caption identifying the statement as disclosure under section 707; (ii) An identification of the item (or group of items) with respect to which disclosure is made; (iii) The amount of each item; and (iv) The facts affecting the potential tax treatment of the item (or items) under section 707. Id. Neither the regulations nor Form 8275 provide guidance on what an "item" means for purposes of this disclosure. Presumably, an "item" includes any portion of the consideration transferred to and from the partnership that could constitute part of a disguised sale of property. Requiring the taxpayer to disclose "the facts affecting the potential tax treatment of the item . . . under section 707" effectively requires a taxpayer to provide the Service with a detailed memorandum explaining all facts and circumstances surrounding the relevant transfers and how those facts "affect" the "potential tax treatment" of the item. If more than one partner transfers property to a partnership pursuant to a plan, the disclosure required under Treas. Reg. § 1.707-8 may be made by the partnership on behalf of all the transferors rather than by each transferor separately. Treas. Reg. § 1.707-8(c).

B. Proposed Disclosure Rules for Disguised Sales of Property

The preamble to the proposed interest regulations stated, "In the Enron Report and the Written Testimony, the Joint Committee [on Taxation] recommended that the period for which disclosure of a transaction is required under the disguised sale rules should be extended beyond two years. The Committee further suggested that expanding the disclosure period to seven years might make it more likely that taxpayers would undertake the facts and circumstances determination for transfers occurring more than two years apart and would make that facts and circumstances determination easier for the IRS to administer."

To carry out this recommendation, the proposed interest regulations proposed to amend the property regulations so that the relevant time period for disclosure was seven years rather than two years. Thus, under Former Prop. Treas. Reg. § 1.707-3(c)(2), disclosure in accordance with Treas. Reg. § 1.707-8 was required if (i) a partner transferred property to a partnership and the partnership transferred money or other consideration to the partner within a <u>seven-year</u> period (without regard to the order), (ii) the partner treated the transfers other than as a disguised sale of property for tax purposes, and (iii) the transfer of money or other consideration to the partner was not presumed to be a guaranteed payment for capital under Treas. Reg. § 1.707-4(a)(ii), was not a reasonable preferred return under Treas. Reg. § 1.707-4(a)(3), and was not an operating cash flow distribution under Treas. Reg. § 1.707-4(b)(2). Also, Former Prop. Treas. Reg. § 1.707-6(c)(1) contained an analogous seven-year disclosure rule for disguised sales of property from a partnership to a partner.

The preamble requested comments regarding whether a period shorter than seven years should have applied. Although the preamble mentioned that extending these disclosure rules to transfers between partners and partnerships over a seven-year period "would make [the] facts and circumstances determination easier for the IRS to administer," such an extension

undoubtedly would have erected an enormous administrative burden for taxpayers. Partners and their partnership would have had to monitor all contributions and distributions on a rolling fourteen-year (rather than four-year) period (i.e., seven years before a particular contribution or distribution and seven years after such contribution or distribution) to determine if a particular partner who contributed any property also received a distribution within any seven-year period, independent of any "relatedness" inquiry. Further, the partners and their partnership would have had to determine whether the relevant distribution to such particular partner was presumed to be a guaranteed payment for capital under Treas. Reg. § 1.707-4(a)(ii), was a reasonable preferred return under Treas. Reg. § 1.707-4(a)(3), or was an operating cash flow distribution under Treas. Reg. § 1.707-4(b)(2). Although the current two-year period for the disclosure rules is appropriate in light of the underlying two-year presumptions in the substantive rules of the property regulations, there is nothing in section 707 or its legislative history that suggests a period any longer than three years would be appropriate. See Treas. Reg. §§ 1.707-3(c), (d), -6(a) (imposing the two-year presumptions regarding disguised sales of property); Former Prop. Treas. Reg. § 1.707-7(c), (d) (imposing the two-year presumptions regarding disguised sales of partnership interests); S. Rep. No. 98-169 (1984) ("These regulations may provide for a period, such as three years, during which contributions by and distributions to the same or another partner normally will be presumed related.") (Emphasis added). Thus, it seems clear that the proposed interest regulations' seven-year period went too far in this respect.

The proposed interest regulations also designated a brand new circumstance in which disclosure would have been required. Under Former Prop. Treas. Reg. § 1.707-5(a)(8), disclosure under Treas. Reg. § 1.707-8 would have been required if (i) a partner transferred property to a partnership, and the partnership assumed or took subject to a liability of the partner

(whether or not the liability is qualified) within a seven-year period (without regard to the order of the transactions), (ii) the partner treated the transactions as other than as a sale for tax purposes, and (iii) the transaction was not otherwise required to be disclosed under Treas. Reg. § 1.707-5. An analogous disclosure rule applied to transfers of property from partnerships to partners under Former Prop. Treas. Reg. § 1.707-6(c)(3).

These proposed disclosure rules had two problems. First, qualified liabilities, as defined in Treas. Reg. § 1.707-5(a)(6), were not excluded. The preamble to the proposed interest regulations stated that qualified liabilities were not excluded due to "a concern that taxpayers are taking unwarranted positions regarding a partner's share of partnership liabilities before or after an assumption of or taking subject to a liability." (Emphasis added). This statement seems to imply that the Service was concerned about a contributing partner taking the position that its share of a liability that it transferred to a partnership was larger than the property regulations permitted so that it could take the position that it had not engaged in a disguised sale of property as a result of the relief of liabilities. Since the determination of a partner's share of a partnership liability under the property regulations is tied directly to the section 752 Treasury regulations, this purported problem does not appear to be unique to transactions potentially falling into section 707(a)(2)(B). Further, partnerships already are required to disclose on Schedule K-1 of Form 1065 each partner's aggregate share of partnership nonrecourse liabilities, partnership recourse liabilities, and partnership qualified nonrecourse liabilities as of the beginning and end of each taxable year. Thus, if any additional disclosure is needed, it seems that the appropriate place would be on Schedule K-1 of Form 1065 (e.g., requiring each partner's share of each partnership liability to be disclosed rather than just aggregate amounts).

Second, these proposed disclosure rules used a seven-year disclosure period. Similar to the proposed disclosure rules mentioned above, there appears to be no basis for imposing any disclosure period greater than three years in either section 707(a)(2)(B) or the legislative history of section 707(a)(2)(B). See Treas. Reg. §§ 1.707-3(c), (d), -6(a) (imposing the two-year presumptions regarding disguised sales of property); Former Prop. Treas. Reg. § 1.707-7(c), (d) (imposing the two-year presumptions regarding disguised sales of partnership interests); S. Rep. No. 98-169 (1984) ("These regulations may provide for a period, such as three years, during which contributions by and distributions to the same or another partner normally will be presumed related.") (Emphasis added).

If this new disclosure obligation had been adopted, virtually every transfer of property to a partnership would have triggered a disclosure obligation. All that was needed to trigger the obligation was a transfer of property and a liability to a partnership within a seven-year period. Thus, any contribution of encumbered property would have triggered this disclosure obligation. For example, the assumption of a liability incurred more than two years before the contribution of the property that serves as security for such liability would have triggered this disclosure obligation, regardless of whether the loan proceeds were used to improve the property or effectively to liquidate the partner's investment in the property. Also, the assumption of trade payables related to a business contributed to a partnership would have triggered this disclosure obligation.

What makes these problems particularly acute for taxpayers is the fact that the required disclosure under Treas. Reg. § 1.707-8 does not amount to filing a simple piece of paper with the Service. As stated above, requiring the taxpayer to disclose "the facts affecting the potential tax treatment of the item . . . under section 707" effectively requires a taxpayer to

provide the Service with a detailed memorandum explaining all facts and circumstances surrounding the relevant transfers and how those facts "affect" the "potential tax treatment" of the item.

The proposed interest regulations also clarified who was required to disclose if a disclosure obligation arose. Under Former Prop. Treas. Reg. § 1.707-8(c), disclosure was required by any person who made a transfer that was required to be disclosed (e.g., a contributing partner) unless a person designated by the other person actually made the required disclosure (e.g., the partnership).

C. Proposed Rules for Disguised Sales of Partnership Interests

Consistent with the proposed disclosure rules for disguised sales of property, the proposed interest regulations provided disclosure rules for disguised sales of partnership interests in certain circumstances. Under Former Prop. Treas. Reg. § 1.707-7(k), disclosure was required under Treas. Reg. § 1.707-8 when (i) a partner transferred consideration to a partnership and the partnership transferred consideration to another partner within a seven-year period (without regard to the order of the transfers), (ii) the partners treated the transfers other than as a sale for tax purposes, and (iii) the transfer of consideration by the partnership was not presumed to be a guaranteed payment for capital under Treas. Reg. § 1.707-4(a)(1)(ii), was not a reasonable preferred return within the meaning of Treas. Reg. § 1.707-4(a)(3), and was not an operating cash flow distribution within the meaning of Treas. Reg. § 1.707-4(b)(2). However, disclosure under Former Prop. Treas. Reg. § 1.707-7(k) was not required if either of the transfers (i) resulted from a termination of a partnership under section 708(b)(1)(B), (ii) related to transfers

incident to the formation of a partnership, or (iii) related to transfers to or by service partnerships in Former Prop. Treas. Reg. § 1.707-7(g). Former Prop. Treas. Reg. § 1.707-7(k).

Like the proposed disclosure rules for disguised sales of property, the seven-year period in Former Prop. Treas. Reg. § 1.707-7(k) presented enormous administrative difficulties for partners and partnerships, and there appears to have been no authority for imposing any period greater than three years. See Former Prop. Treas. Reg. § 1.707-7(c), (d) (imposing the two-year presumptions regarding disguised sales of partnership interests); Treas. Reg. §§ 1.707-3(c), (d), -6(a) (imposing the two-year presumptions regarding disguised sales of property); S. Rep. No. 98-169 (1984) ("These regulations may provide for a period, such as three years, during which contributions by and distributions to the same or another partner normally will be presumed related.") (Emphasis added).

D. Proposed Effective Date of Disclosure Rules

Former Prop. Treas. Reg. § 1.707-9 provided that the disclosure rules in the proposed interest regulations (i.e., the proposed rules applicable to disguised sales of partnership interests as well as property) would have applied only to a transaction with respect to which all transfers that were part of a sale of property or a partnership interest occurred on or after the date the proposed interest regulations were published as final Treasury regulations.