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PARTNERSHIP DISGUISED SALE RULES

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Partnership Disguised Sale Rules

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 prevents the contributing partner and the partnership from recognizing gain or loss on the contribution, and section 731 generally 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 will be treated as a sale or exchange between the partner and the partnership.

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) prevents the contributing partner and the partnership from recognizing gain or loss on the contribution, and section 731 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.

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” is to a section of the Internal Revenue Code of 1986 (the “Code”), as amended from time to time.

Prior to 1984, it was unclear whether a partner could engage in a disguised sale of property or 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 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 “IRS”) issued final Treasury regulations regarding the disguised sale of property (the “disguised property rules”). Such regulations are widely regarded as providing a workable structure of rules without the imposition of 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 IRS issued proposed Treasury regulations regarding the disguised sale of partnership interests (the “disguised interest rules”). Although many of the proposed disguised interest rules are similar to the disguised property rules, certain aspects of the disguised interest rules significantly increase the complexity of section 707(a)(2)(B) and the administrative burden for taxpayers.

The succeeding sections of this outline trace the gradual development of the rules regarding disguised sales involving partners and partnerships. A detailed discussion is included regarding the case law prior to the enactment of section 707(a)(2)(B), the final disguised property rules, and the proposed disguised interest rules.

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: “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 the IRS 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 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 their substance. Accordingly, this Treasury regulation appeared 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).

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 emphasized (and still emphasizes) that the substance over form principle controls the tax treatment of any putative contribution described in section 721(a). Furthermore, it confirmed that, if a transfer of property by a partner to a partnership was not a contribution in substance, the transfer would 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 regulation focuses on the substance over form principle. However, this regulation expands the apparent scope of the potential recasts of a disguised sale of property. The regulation 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 regulation’s reference to transactions between partners may not be viewed as referring to disguised sales of partnership interests. However, in the case of a disguised sale of property between partners, the words of the 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 regulation’s focus on the treatment of the putative distribution of property without addressing the treatment of the putative contribution.

C. Relevant Case Law

Against this backdrop of statutory and regulatory guidance prior to 1984, there was considerable controversy 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. Courts failed to find a disguised sale in three cases and found disguised sales in two others.

a. Case Law Not Finding a Disguised Sale

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

(1) 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. So, the taxpayer 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 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.

(2) 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.

(3) 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 (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 (“FMV”) 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 and distribution 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 Tax Court then applied a facts and circumstances approach to determining the substance of the transactions. The Tax 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 a partnership interest)

(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 because of uncertainties in attempting to value 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. Jupiter Corp. v. United States, 2 Cl. Ct. 58 (1983) (no disguised sale)

(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 reduced 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 in the Internal Revenue Code (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 (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 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."

2. Case Law Finding a Disguised Sale

- a. Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971) (disguised sale of a 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 a 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 reduced 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 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 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 discussed section 707(a)(2)(B) in a footnote but could not apply it since the relevant transactions occurred prior to the effective date of the statute.

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

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

Presumably in response to 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.

The legislative history evidences an intent by Congress that Treasury would issue regulations that would carry out the purpose of section 707(a)(2)(B).

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

2. House Report:

The House report is in all material respects identical to the Senate report. See H. Rep. No. 98-432 (1984).

3. House Conference Report

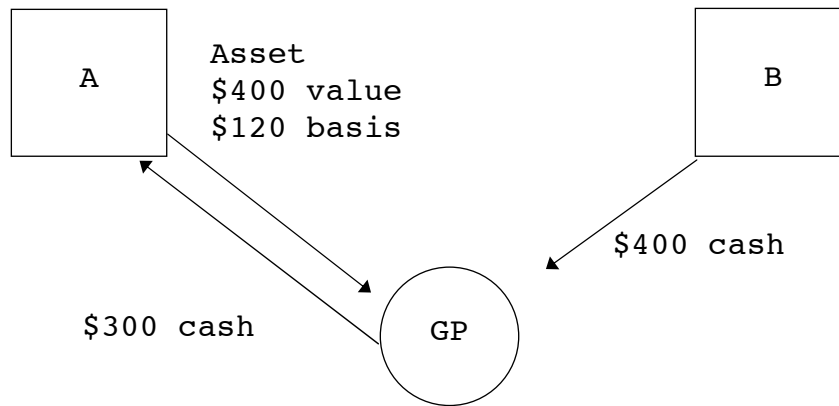
“The conferees wish to note that when a partner of a partnership contributes property to the partnership and that property is borrowed against, pledged as collateral for a loan, or otherwise refinanced, and the proceeds of the loan are distributed to the contributing partner, there will be no disguised 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).

IV. Administrative Guidance on Disguised Sales of Property

After nearly seven years, proposed regulations were published under section 707(a)(2) on April 25, 1991. See 56 Fed. Reg. 19,055-02 (Apr. 25, 1991). The final regulations were published on September 30, 1992. See 57 Fed. Reg. 44,974-01 (Sept. 30, 1992). The 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

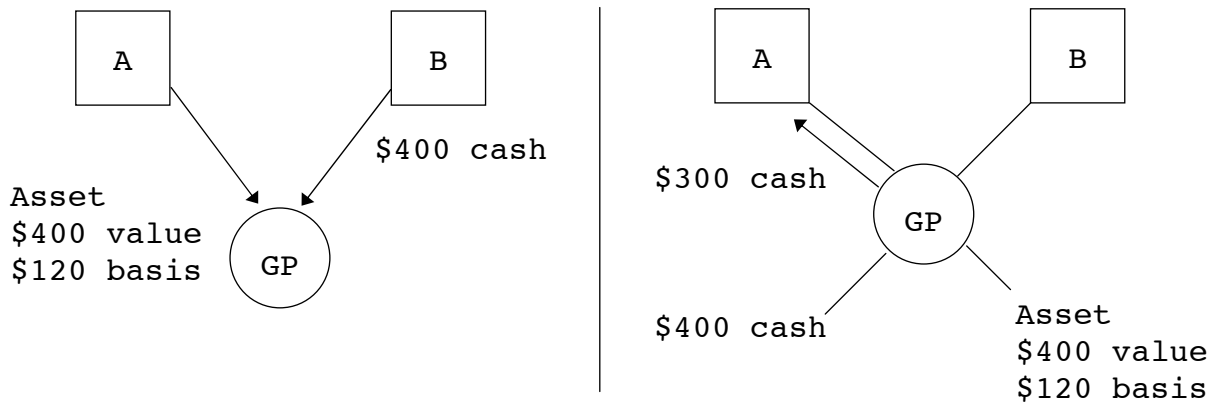
1. A contributes an asset with a \$400 value and a \$120 basis to GP in exchange for a 20% interest. B contributes \$400 cash to GP in exchange for a 80% interest. Immediately after the contributions, GP distributes \$300 cash to A.
2. In the case of a simultaneous contribution and distribution, a disguised sale 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 would 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 a 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 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).

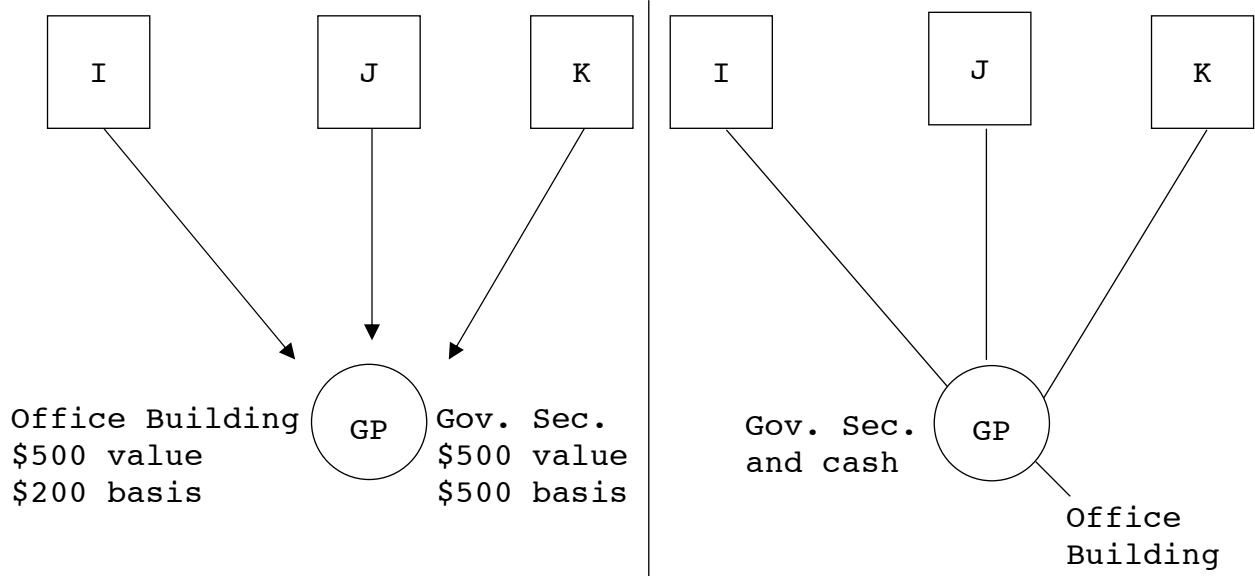
- c. Given the facts and circumstances that (1) the partnership agreement requires that money be distributed to A nine months after GP's formation and (2) B is required to make up any shortfall with additional capital contributions, and given that the transfers fall within the two-year rule and are presumed 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 final 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 final 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 final regulations, the Internal Revenue Service (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.

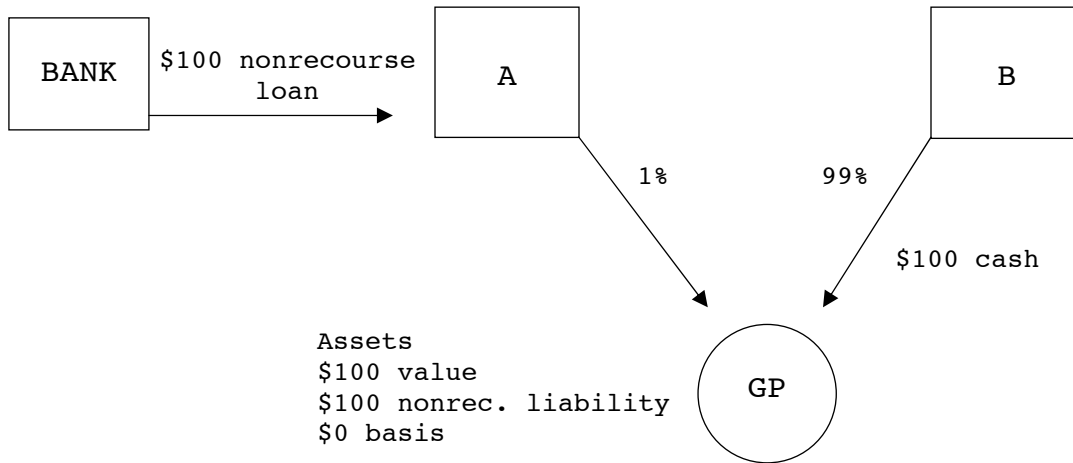
2. It is not expected that the partnership will need to resort to the government securities or the cash flow therefrom to operate the building. At the time the partnership is formed, the partners "contemplated" that I's interest in the partnership would be liquidated

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 was deemed to be a disguised sale payment. 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).

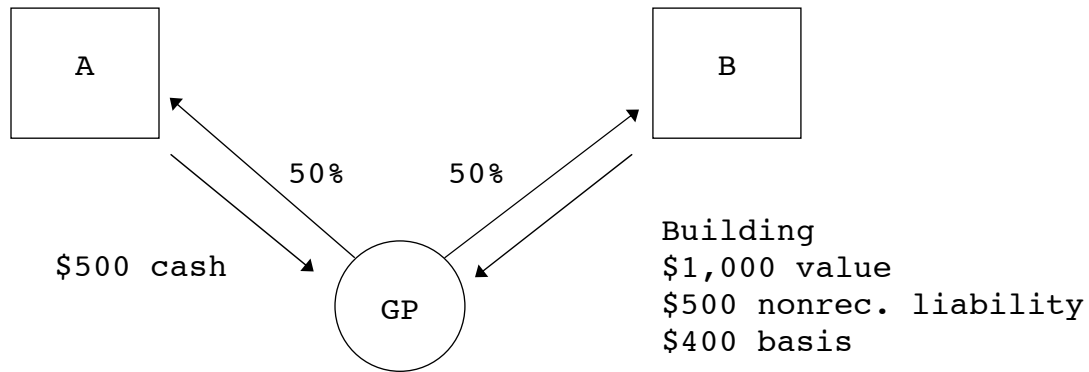
5. If a contribution of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership's assumption of or taking subject to a qualified liability in connection with the contribution of property will not be treated as part of a sale.
 - a. If property encumbered by 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 disguised sale 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 section 707(a)(2) 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.
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).

- a. Under the proposed 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). 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), 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., $(\$40/\$100) \times \$80$), 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

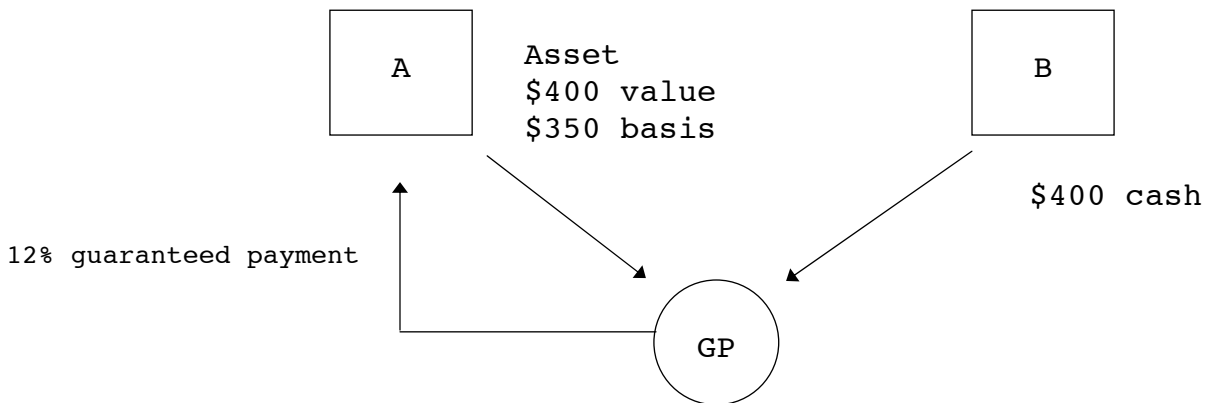
never result in disguised sale treatment, while a transfer of higher basis property subject to a nonrecourse liability would -- a nonsensical result.

8. Should a contribution of property subject to a nonrecourse liability ever 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. Comm’r, 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 final 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 disguised sale 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 final 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 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 final 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.

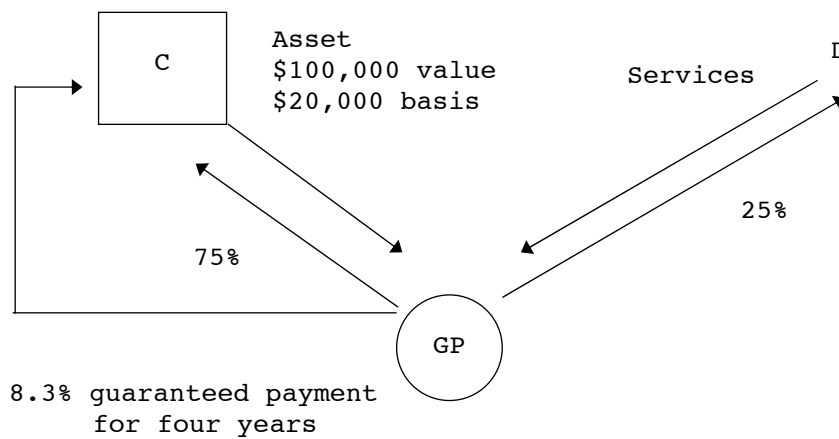
This presumption can only be rebutted by facts and circumstances (including the likelihood and expected timing of the matching allocation of income or gain to support the preferred return) that clearly establish that the transfer is part of a sale. Treas. Reg. § 1.707-4(a)(2).

- 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 final 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 final 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 beginning 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

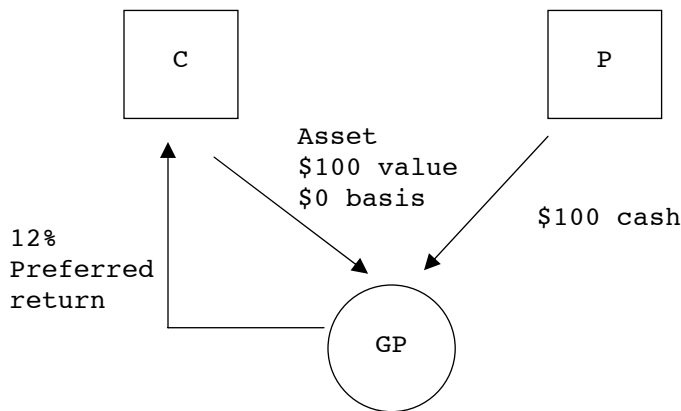


1. The above diagram is based on Example 2 in Treas. Reg. § 1.707-4(a)(4). C contributes property with a \$100,000 value and \$20,000 basis to the partnership. D contributes no capital but manages the operations of the partnership.
2. C is to receive a guaranteed payment for capital of \$8,333 per year 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.

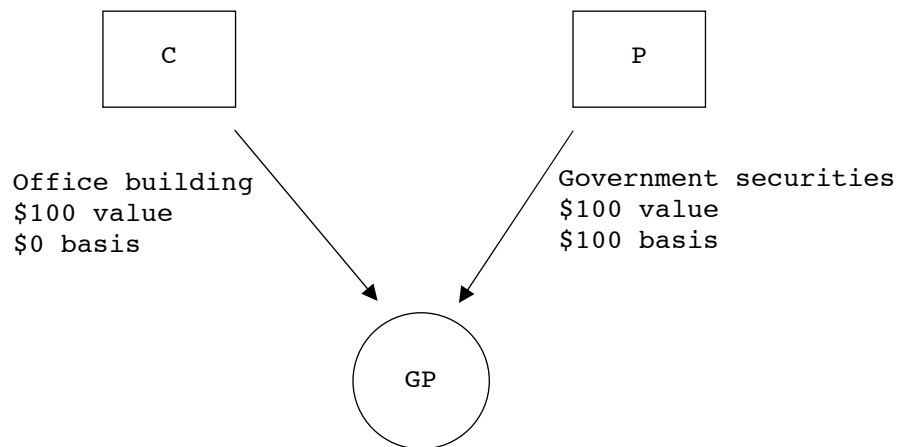
Partnership Disguised Sale Rules:
Preferred Return and Pledge of Partnership Interest



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 1% 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 final disguised sale regulations under section 707(a), 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 was 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

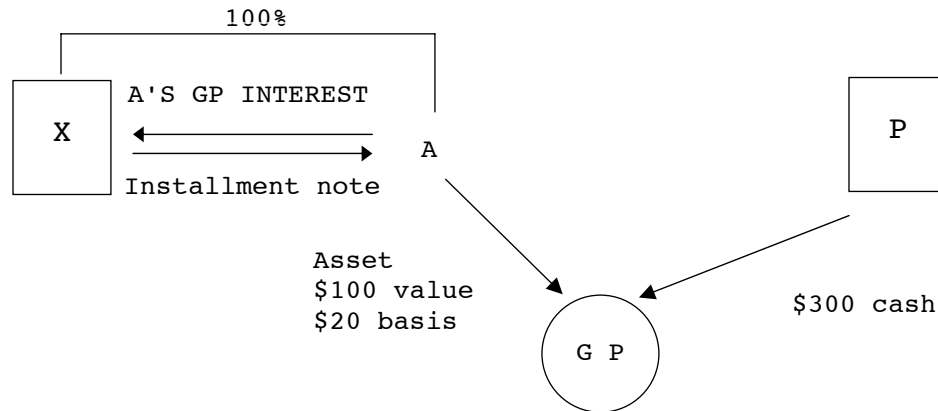


1. C contributes an office building to the partnership with a \$100 value and \$0 basis. The office building is substantially leased on a long-term basis.
2. P contributes government securities to the partnership with a \$100 value and a \$100 basis.
3. All items of income, gain, loss, and deduction 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 disguised sale 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, 2003-34 I.R.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

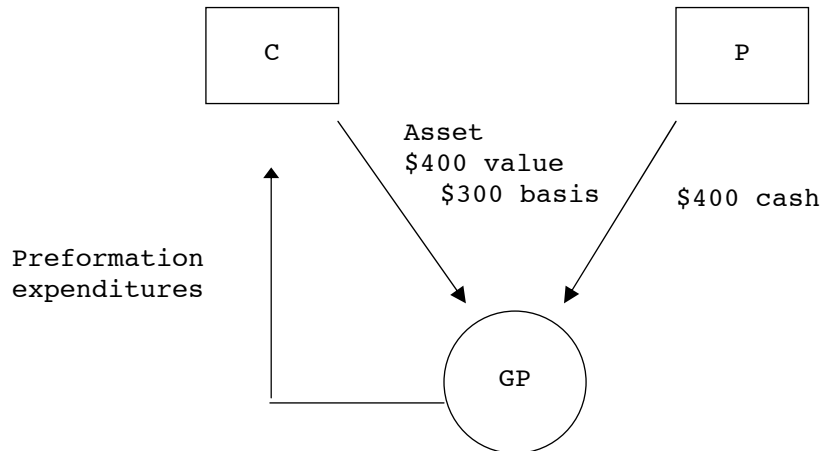


1. Individual A contributes an asset with a \$100 value and a \$20 basis to the partnership in exchange for a 25% interest. P contributes \$300 cash to the partnership in exchange for a 75% interest.
2. A sells its partnership interest to X, an S corporation wholly owned by A, for a \$100 note. A reports 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 final 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



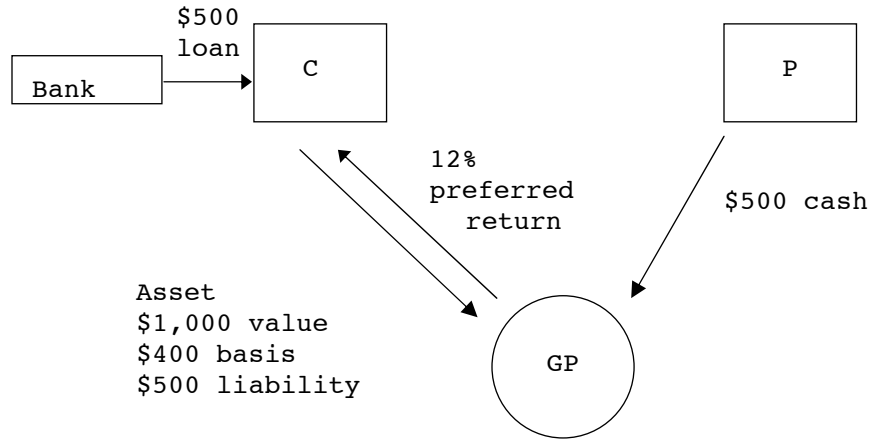
1. C acquired property more than two years ago for \$180 and spent \$20 improving the property at that time.
2. C contributes to the partnership the property, which has a \$400 value and \$300 basis. Shortly before the contribution, C spent \$100 to further improve the property. P contributes \$400 cash to the partnership.
3. The final 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 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 liabilities.
2. Four categories of liabilities are "qualified liabilities." Treas. Reg. § 1.707-5(a)(6)(i). See 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. Comm'r, 24 T.C. 659 (1955); see also Republic Petroleum Corp. v. United States, 613 F.2d 518 (5th Cir. 1980); United Pac. Corp. v. Comm'r, 39 T.C. 721 (1963); Estate of Lamberth v. Comm'r, 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. Comm'r, 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. Comm'r, 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. Comm'r, 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. 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. However, the Service, in a handful of administrative pronouncements, has applied section 707(a)(2)(B) to find a disguised sale of a partnership interest. See TAM 200301004; TAM 200037005; CCA 200250013; CCA 200224007 (Feb. 27, 2002); FSA 200024001 (Feb. 8, 2000).

The Service has determined that, in applying section 707(a)(2)(B) in the absence of regulations, taxpayers should use the statutory language of section 707(a)(2)(B) and the guidance in the legislative history. See Notice 2001-64 (providing that the statute and the guidance in the legislative history should be applied in the absence of 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)).

Although the Treasury and the Service recently issued proposed regulations on disguised sales of partnership interests, these regulations are only proposed regulations. Proposed regulations generally are given little to no deference by courts. [cite]. Thus, the non-regulatory administrative guidance issued prior to the issuance of the proposed regulations should remain relevant to any disguised sale inquiry.

A. Administrative Guidance Prior to Issuance of Proposed Regulations

1. Notice 2001-64, 2001-41 I.R.B. 316 (Oct. 14, 2001)

The Service requested comments on the scope and substance of proposed 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.” Notice 2001-64.

2. Relevant IRS Written Determinations

The Service has attempted to recharacterize transactions as disguised sales of partnership interests, regardless of the fact that regulations have not been issued. 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

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)

(1) Facts

[Note that this CCA was written by David Haglund, author of the section 707(a)(2)(B) property regulations.] 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.

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

(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.

(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)

(1) Facts

[Note that this CCA was drafted by an international tax lawyer rather than a pass-throughs lawyer.] 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 Regulations

On November 24, 2004, the Service and the Treasury issued proposed Treasury regulations regarding disguised sales of partnership interests (the "proposed interest regulations"). See [cite]. Although many of the rules in the proposed interest regulations are similar to the rules in the property regulations, certain aspects of the proposed interest regulations increase the complexity of section 707(a)(2)(B) and the administrative burden for taxpayers.

1. General Rules

a) Overall Rule

Except as otherwise provided in 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") meet the general facts and circumstances test (discussed below), the transfers will be treated as a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner. Prop. Treas. Reg. § 1.707-7(a)(1).

b) General Facts and Circumstances Rule

The general facts and circumstances test is 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 constitute 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 is not dependent on the entrepreneurial risks of partnership operations (i.e., the "risk test"). Prop. Treas. Reg. § 1.707-7(b)(1).

This test is 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 sweeps 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 stands to sweep more broadly, because it will capture 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 seems 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 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 will be taken into account in applying the general facts and circumstances test. Prop. Treas. Reg. § 1.707-7(b)(2). The weight to be given each of the facts and circumstances will depend on the particular case. Id. Generally, the facts and circumstances existing on the date of the earliest of the transfers are the ones considered in

determining if a disguised sale exists. *Id.* The proposed interest regulations provide a nonexclusive list of facts and circumstances that may tend to prove the existence of a disguised sale. They are similar to the list in the property regulations with some additions. Like the property regulations, the proposed interest regulations do not indicate (either by rule or example) whether any one listed fact and circumstance is sufficient to find a disguised sale. Like the property regulations, the proposed interest regulations also do not indicate what types of facts and circumstances tend to prove that a disguised sale does not exist (i.e., only negative factors are listed). Although a taxpayer might assume that proving that the listed negative factors do not exist would prevent a disguised sale finding, the proposed interest regulations do not contain such a rule.

(1) Listed Facts and Circumstances Tending to Prove Disguised Sale

- (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. 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 that elapses between transfers. As discussed in more detail below, if transfers are made within two years, it is presumed that the transfers constituted a disguised sale of a partnership interest, and, if transfers are not made within two years, it is presumed that the transfers did not constitute a disguised sale of a partnership interest. Prop. Treas. Reg. § 1.707-7(c), (d). If either of the presumptions are met, only facts and circumstances that clearly establish otherwise may rebut the presumptions. Id. As

a result, the presumptions effectively operate as substantive rules, except in the rare cases that involve straightforward factual circumstances.

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.” [cite preamble]. To the contrary, it appears that the two-year presumption in favor of disguised sale treatment effectively eliminates the need for the Service and Treasury to scrutinize the transaction further. The presumption operates against the taxpayer unless the taxpayer clearly establishes otherwise.

The Service and Treasury apparently need not 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 provide 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.” Prop. Treas. Reg. § 1.707-7(c). As stated in the regulations, this presumption may be rebutted with facts and circumstances that clearly establish otherwise.

This presumption also may be 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).

However, the prospect that this two-year presumption may be avoided by meeting certain presumptions or exceptions does 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 applies and whether any offsetting presumptions or safe-harbors apply. This will increase 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 provide 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.” Prop. Treas. Reg. § 1.707-7(d). As stated, this presumption may be rebutted with facts and circumstances that clearly establish otherwise.

b) Cash Liquidation Presumption

The Service and the Treasury state 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.” According the proposed interest regulations contain 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." Prop. Treas. Reg. § 1.707-7(e). If there is enough risk of disguised sale treatment with the distribution of property in liquidating of a partner's interest in the partnership, this presumption appears 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 apply 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 disguised property rules regarding guarantee payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures apply in determining the extent to which a transfer to a selling partner is treated as part of a sale of the selling partner's interest in the partnership to the purchasing partner. The preamble states that the extension of these rules to the disguised sale of a partnership interest context is 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” are excepted from section 707(a)(2)(B) and the proposed interest regulations. Prop. Treas. Reg. § 1.707-7(g). The preamble states: “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 appears to have a much broader application, because the exception explicitly states that “section 707(a)(2)(B)” does not apply to such transfers. The reference to section 707(a)(2)(B) presumably makes the exception applicable to all transactions covered by section 707(a)(2)(B), including disguised sales of property transactions. However, this presumed breadth may be illusory, since this exception is 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. However, the issue is not free from doubt.

For purposes of this exception, a “service partnership” is 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 rely upon this exception, it will have to monitor continually its activities and its ownership structure to ensure that the section 448(d)(2) “function test” and the “ownership test” are 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 requests comments regarding whether transfers to and from other types of partnerships should be 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 be limited, a blanket exception for such partnerships might invite abuse. Therefore, a rebuttable presumption against disguised sale treatment for all transfers to and from such partnerships appears to be an appropriately balanced approach (i.e., most of such transfers are not effected to disguised 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 are excepted from the proposed interest regulations. Prop. Treas. Reg. § 1.707-7(a)(8). Like the service partnership exception, this exception also refers to transfers being excepted from “section 707(a)(2)(B),” which presumably broadens its reach to disguised sales of property. However, unlike the service partnership exception, the proposed interest regulations provide that transfers incident to the formation of a partnership may be transfers to which the disguised property regulations apply.

Neither the proposed interest regulations nor their preamble indicate what transfers should be considered “incident to the formation of a partnership.” Does this mean that only the first transfers of money or property to a partnership are excepted? Does this mean that all transfers of money or property to a partnership during the year the partnership begins conducting business are excepted?

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

Deemed transfers resulting from a termination of a partnership under section 708(b)(1)(B) are excepted from the proposed interest regulations. Prop. Treas. Reg. § 1.707-7(a)(8). Like the service partnership exception, this exception also refers to transfers being excepted from “section 707(a)(2)(B),” which presumably broadens 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 is determined that the relevant partnership has terminated under section 708(b)(1)(A), the proposed interest regulations will apply to the transfers to and from such partnership leading up to its termination. Prop. Treas. Reg. § 1.707-7(a)(7). For example, if transfers to and from a partnership would be 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 terminates upon such deemed sale does not defeat such disguised sale treatment.

e) Application of Property Rules

To the extent that any transfer that would otherwise be taken into account under the proposed interest regulations “may” be treated as a sale of property under the disguised property regulations, the disguised property regulations apply before the proposed interest regulations. Prop. Treas. Reg. § 1.707-7(a)(6). This ordering rule apparently means that the disclosure rules in the disguised property regulations take precedence over the disclosure rules in the proposed interest regulations. Furthermore, to the extent any transfer “is” treated as part of a disguised sale of property, such transfer is not taken into account in apply the disguised interest regulations. Id. With respect to this aspect of the rule, the preamble states: “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 may provide formal guidance that section 707(a)(2)(B) and the proposed interest regulations do not apply to other transfers to and by a partnership. Prop. Treas. Reg. § 1.707-7(h).

g) Specific Safe-Harbors and Exceptions Not Adopted

The preamble discusses several proposed safe-harbors and exceptions that were not adopted as part of the proposed interest regulations. The proposed interest regulations do not adopt a specific favorable presumption or safe-harbor for transactions involving transfers of different property. The preamble explains that the Service and Treasury are 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 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 are 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 is 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 acquired 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 acquired 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 the Treasury are 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 believe 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 follow the approach of the property regulations with respect to the treatment of liabilities. However, there is a significant difference. Unlike the property regulations, the proposed interest regulations do not include any special rules for "qualified liabilities." The preamble states "qualified liability" rules were omitted, since a transfer to a partnership of encumbered property alone would not be subject to recharacterization as a disguised sale of a partnership interest, but such a transfer alone could be 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 cause the transfer of encumbered property to be disregarded. At most, only the deemed distribution of cash from the relief of the encumbrance would be disregarded. The actual transfer of the property still could form 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 produces inappropriate results under the proposed interest regulations. For example, assume A and B form an equal general partnership in 2005. In 2006, A contributes property worth \$100 that is subject to a \$40 liability that was incurred more than two years ago to construct \$40 of improvements on the property, and B contributes \$60 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 \$20 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 \$20 of the liability is not disregarded for purposes of applying the proposed interest regulations. Thus, since B transferred \$60 of consideration to the partnership and (at the same time) A is treated as receiving \$20 of consideration from the partnership, the proposed interest regulations presume that A sold \$20 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 does not trigger a disguised sale of property.

a) Reallocation of Partnership Liability

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).”).

In addition to the legislative history, 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"). See also 2003 TNT 44-15 (March 6, 2003) (New York State Bar Association formal comments on disguised sales of partnership interests concluding that the shifting of partnership-level liabilities among partners generally should not be taken into account in analyzing a disguised sale of a partnership interest).

Apparently relying on the legislative history of section 707(a)(2)(B) (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 state: "[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." Prop. Treas. Reg. § 1.707-7(j)(1). However, the proposed interest regulations provide further that, if a "transaction" is otherwise treated as a sale of a partnership interest under the proposed interest regulations, any deemed contributions and distributions under section 752 will be taken into account. Id. The proposed interest regulations do 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 should be taken into account.

b) Assumption by Partnership

The proposed interest regulations adopt the same rules regarding assumptions of liabilities by partnerships as the rules in the property regulations. If a partnership assumes a liability of a partner (under the rules in Treas. Reg. §§ 1.752-1(d) and (e)), the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner’s share of that liability (as described below) immediately after the partnership assumes the liability. Prop. Treas. Reg. § 1.707-7(j)(2). However, if, pursuant to a plan, a partner pays or contributes money to the partnership and the partnership assumes one or more liabilities of the partner, the amount of those liabilities that the partnership is treated as assuming is reduced (but not below zero) by the money transferred. Prop. Treas. Reg. § 1.707-7(j)(7).

If the partnership assumes 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 equals the sum of that partner’s shares of the liabilities assumed by the partnership pursuant to the plan. Prop. Treas. Reg. § 1.707-7(j)(2). However, this special aggregation rule does not apply to any liability assumed by the partnership with a principal purpose of reducing the extent to which any other liability assumed the partnership is treated as a transfer of consideration to a partner. Id.

Furthermore, an anti-abuse rule applies in situations where the partners plan to temporarily increase or preserve a partner's share of a partnership liability so as to avoid a disguised sale risk which is 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 assumes the liability, is determined by taking into account a subsequent reduction in the partner's share if the following two conditions are satisfied: (i) At the time that the partnership assumes a liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced; and (ii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of the liability is treated as part of a sale. Prop. Treas. Reg. § 1.707-7(j)(5).

c) Assumption by Partner

The proposed interest regulations also adopt the same rules regarding assumptions of liabilities by partners as the rules in the property regulations. If a partner assumes 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 is treated as transferring consideration to the partnership to the extent that the amount of the liability exceeds the partner's share of that liability (as described below) immediately before the partner assumes the liability. Prop. Treas. Reg. § 1.707-7(j)(3). However, if, pursuant to a plan, a partnership pays or distributes money to a partner and the partner assumes one or more liabilities of the partnership, the amount of those liabilities that the partner is treated as assuming is reduced (but not below zero) by the money transferred. Prop. Treas. Reg. § 1.707-7(j)(7).

If more than one partner assumes a partnership liability pursuant to a plan, the amount that is treated as a transfer of consideration by each partner is the amount by which all of

the liabilities assumed by the partner pursuant to the plan exceed the partner's share of all of those liabilities immediately before the assumption. Prop. Treas. Reg. § 1.707-7(j)(3). However, this special aggregation rule does 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 is 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 that involves liabilities.

The proposed interest regulations adopt 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 equals 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). Prop. Treas. Reg. § 1.707-7(j)(4). 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 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 is modified so as to prohibit a partner from determining its share of a partnership liability based on its share of section 704(c) gain with respect to property that is subject to the relevant partnership liability. Prop. Treas. Reg. § 1.752-3(a)(3).

Since the proposed interest regulations use 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) are 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 include 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 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 adopt the same rules regarding debt-financed transfers of consideration by partnerships as the rules in the property regulations. If a partnership incurs a liability and all or a portion of the proceeds of that liability are 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 is taken into account only to the extent that the amount of consideration transferred exceeds that partner's "allocable share" of the partnership liability. Prop. Treas. Reg. § 1.707-7(j)(6). Generally, a partner's "allocable share" of a partnership liability equals 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 is 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 transfers 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 as one liability, and each partner's allocable share of those liabilities equals 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 is 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 does not apply to any transfer of consideration to a partner that is made with a principal purpose of reducing the extent to which any transfer is taken into account under the general rule for debt-financed transfers. Id.

A special anti-abuse rule applies to these debt-financed transfers. A partner's share of a liability is determined by taking into account a subsequent reduction in the partner's share if (i) it is anticipated that the partner's share of the liability that is allocable to a transfer of consideration to the partner will be reduced subsequent to the transfer, and (ii) the reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes

minimizing the extent to which the partnership's distribution of the proceeds of the borrowing is treated as part of a sale. Id.

As described above, in order for the debt-financed transfer rule to apply, a partner must receive a distribution of loan proceeds that is 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 are 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 follow either of the following four lending procedures to ensure that it meets the debt-financed transfer rule. First, the partnership

should direct the bank to transfer the loan proceeds directly to the partner. Second, the partnership should receive the loan proceeds and immediately transfer the proceeds to the partner. Third, the partnership should receive the loan proceeds, deposit the proceeds into a new bank account, and then transfer cash from the account to the partner within 90 days. Fourth, the partnership should receive the loan proceeds, deposit the proceeds into an existing bank account, and then transfer cash from the account to the partner within 15 days of such deposit. See Temp. Treas. Reg. § 1.163-8T(c).

As described above, in order to ensure that no part of the debt-financed transfer of proceeds to a partner is 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) must equal or exceed the ratio of the portion 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 cannot rely 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 must 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 Prop. Treas. Reg. § 1.707-7(j), Member A's share of such liability under the general liability-sharing rules is 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 is 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 is protected from disguised sale treatment under the debt-financed transfer rule. In order to ensure that no part of the \$80 transfer is treated as part of a disguised sale, Member A could guarantee the entire \$100 partnership liability, which would increase 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 equal 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 equal 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 be 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 may be treated as a transfer of consideration by the partner to the partnership if, (i) within a short period of time after the partnership incurs or assumes 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 bears an economic

risk for the liability that is “disproportionate” to the partner’s interest in profits or capital, and (ii) the transactions are undertaken pursuant to a plan that has as one of its principal purposes minimizing the extent to which the partner is treated as making a transfer of consideration to the partnership that may be treated as part of a disguised sale. Prop. Treas. Reg. § 1.707-7(j)(8). Neither the preamble to the proposed interest regulations nor the examples illuminate 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 are treated as a sale of a partnership interest under such regulations are treated as a sale for all purposes of the Internal Revenue Code. Prop. Treas. Reg. § 1.707-7(a)(2)(i). The regulations list the following sections in which such treatment is 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 will produce 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 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 IRS 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 paper, 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 paper 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 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 provide that certain transfers will be treated as a disguised sale of a partnership interest for all purposes of the Internal Revenue Code. They also outline in detail the precise steps taxpayers are treated as taking with respect to a

disguised sale for all purposes of the Internal Revenue Code. Prop. Treas. Reg. § 1.707-7(a)(2). This aspect of the proposed interest regulations stands to create considerable complexity and administrative burdens.

(1) Timing of Deemed Transactions

Under the proposed interest regulations, a transfer of consideration is treated as occurring on the date of the actual transfer or, if earlier, on the date that the transferor agrees in writing to make the transfer. Prop. Treas. Reg. § 1.707-7(a)(2)(ii)(A). This rule does not seem to create any problems. However, the proposed interest regulations also provide that the sale and the purchase of a selling partner's partnership interest are considered to take place on the date of the earliest of the transfers that constitute the disguised sale for all purposes of the Code. Id. As will be described below in more detail, this rule stands 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 are treated as a sale under the regulations, the selling partner is 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. 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 are aggregated. Id. In those cases, each purchasing partner is 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 is 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 includes any reduction in the selling partner's share of partnership liabilities that is treated as occurring as a result of the sale. 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 occur on the same date that is not treated as part of the disguised sale, the reduction in the selling partner's share of partnership liabilities is 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 is not treated as part of a sale of the selling partner's partnership interest (i.e., the "excess distribution") and the sale is treated as occurring on the same date as the excess distribution, then the excess distribution is treated as occurring immediately following the sale. Prop. Treas. Reg. § 1.707-7(a)(5). This rule appears 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 reduce 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 are “simultaneous” and the consideration transferred is “the same,” the partners and the partnership are 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. Prop. Treas. Reg. § 1.707-7(a)(2)(ii)(B).

The use of the word “simultaneous” appears to mean that transfers occurring even one minute (even one second) apart would not fall into this rule (i.e., the only transfers falling into this rule presumably would be transfers that are 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 seems to have a very limited application. Query whether “simultaneous” should be replaced with a concept that captures transfers to and from partnerships that occur in the same taxable year of the partnership.

Further, what is meant by “the same” consideration in the context of transfers to and from a partnership of money? Query whether this means that some sort of tracing requirement must be 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

apply 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 be 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 are “simultaneous” and the consideration transferred is not “the same,” the partners and the partnership are 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”). Prop. Treas. Reg. § 1.707-7(a)(2)(ii)(B). Again, this rule presents 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 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 does not address why the exchange first recast is used rather than the sale first recast.

It appears that the tax results to the partners and the partnership under both recasts could be 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 is preferable since it avoids 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 cause the purchasing partner to recognize any built-in gain or loss in the consideration actually transferred to the partnership and the partnership to recognize 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 be taken into account by all persons who were partners at the time of the initial exchange transaction in accordance with section 704. This has two effects: (i) The selling partner's distributive share of the gain or loss would adjust 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 take 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 cause the purchasing partner to recognize 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 the partnership to recognize 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 occurs after the initial sale transaction, would not affect the adjusted basis of the selling partner's partnership interest, thereby potentially duplicating built-in gain or loss. Further, the initial sale transaction could cause the partnership to terminate under section 708(b)(1)(A) (e.g., by reducing the number of partners from two to one), which could cause 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 trigger basis adjustments to partnership property if a section 754 election is in effect (or, in certain cases, regardless of a section 754 election). These basis adjustments could affect 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 be 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. See CSC, Jupiter. Thus, the case does not appear as strong to draft the proposed interest

regulations so they apply to nonsimultaneous transfers. Although, it does appear that there is 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 or another partner normally will be presumed related.”). Unfortunately, extending the regulations to such transfers will inject 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) Transfer to Selling Partner First

Under the proposed interest regulations, if the transfer by the partnership to the selling partner occurs before the transfer of consideration by the purchasing partner to the partnership, the partners and the partnership are 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”). 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 are treated as if the purchasing partner satisfied its obligation to deliver the purchasing partner’s consideration to the partnership (the “satisfaction transaction”). Id.

(b) Transfer by Purchasing Partner First

Under the proposed interest regulations, if the transfer of consideration by the partnership occurs after the transfer of consideration by the purchasing partner to the partnership, the partners and the partnership are treated as if, on the date of the sale (i.e., 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"). 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 are 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 treats the disguised sale as occurring on the date of the earliest of the transfers, and the recasts for nonsimultaneous transfers creates the greatest risk that taxpayers will unknowingly stumble into a substantive and administrative disguised sale nightmare.

The following example demonstrates this potential nightmare. 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 sells the remaining portion of the depreciable property to an unrelated party, Q, for \$900. Later in November 2006, another unrelated partner, 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 is 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 is 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 \$100 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 is treated as purchasing 75 percent (i.e., \$600/\$800) of S's partnership interest in December 2004 under the proposed interest regulations, several issues arise.

First, the basis and capital account effects of the distribution to S and the contribution by P must be ignored for all purposes of the Code. The section 704(b) partnership revaluation would be 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 to be taken into account from November 2004 to the present reporting year. For example, P would be entitled to take into account 60 percent of all PS tax items and 60 percent of the recourse partnership liability, and S would have been entitled to take into account only 20 percent of all PS tax items and 20 percent of the recourse partnership liability. 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 must be 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 will affect the bases of partnership assets only with respect to the acquiring partner rather than with respect to all partners, like a section 734(b) adjustment.

Fourth, the disguised sale of 75 percent of S's partnership interest amounts 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 to apply 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 cause 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 accelerate the deemed distributions of cash to S and Q from 2006 to 2004, which could trigger gain to S and Q under section 731.

Seventh, since P would be 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 be 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 treat 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 cause PS to recognize all the built-in gain in the portion of the depreciable property

actually distributed to S, which would affect 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 affect all the partners' capital accounts and bases in their partnership interests.

Ninth, all of the preceding changes would cause PS to file amended partnership returns, to issue amended Form K-1s to S and Q 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 cause S, Q, 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!

6. Examples

VI. 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 expand these disclosures rules in a dramatic way.

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. 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

C.

D. Proposed Rules for Disguised Sales of Partnership Interests

Insert edits from Ashland memo

Insert edits from my first review

Insert pictures for examples