REPORT ON DISGUISED SALES OF PARTNERSHIP INTERESTS RESPONDING TO NOTICE 2001-64

This report[1] responds to Notice 2001-64[2], which states that the Internal Revenue Service and the Treasury Department are considering issuing proposed regulations (the "New Regulations") relating to disguised sales of partnership interests and requests comments on the scope and substance of the regulations, including any applicable safe harbors and exceptions.

1. Recommendations

Our principal recommendations are:

1) The New Regulations should adopt the same basic framework used under the existing regulations governing disguised sales of property between partners and partnerships. Accordingly, the New Regulations should prescribe a general rule that applies based on "all of the facts and circumstances" and a variety of presumptions and safe harbors.

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1 This report was prepared by members of the Committee on Partnerships of the New York State Bar Association. The principal author was David H. Schnabel; substantial contributions were received from William B. Brannan, Patrick C. Gallagher and David A. Stein; helpful comments were received from Andrew N. Berg, Kimberly S. Blanchard, Samuel J. Dimon, Stephen P. Foley, Michael Levin, Newton W. Mandel, Jeffrey J. Tolin, Yaron Z. Reich and Michael Schler.

2 I.R.B. 2001-41, 316 (Oct. 14, 2001).

2) The general rule under the New Regulations for determining whether there has been a disguised sale of a partnership interest should be narrower than the general rule applicable under the existing regulations, and the New Regulations should require, as a predicate to disguised sale treatment, that the transfer to the partnership and the transfer from the partnership be "directly related".

3) Deemed contributions and deemed distributions under Section 752 generally should be disregarded in determining whether there has been a disguised sale of a partnership interest under the New Regulations but should adopt a limited anti-abuse rule to cover certain debt-financed distributions. However, if a disguised sale is found without regard to such liabilities, the amount of such liabilities should be taken into account in determining the amount realized on such sale under normal Subchapter K principles.[3]

4) The New Regulations should include a variety of examples illustrating the application of the general rule to certain routine partnership transactions.

2. Background

Section[4] 707(a)(2)(B) provides that, under regulations, if (i) there is a direct or

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[3] *See* Treas. Reg. § 1.1001-2(c) Example (3) (amount realized includes deemed distribution under Section 752 by reason of reduction in share of partnership liability as a result of sale of partnership interest).

[4] Unless otherwise indicated, all "section" references herein are to the Internal Revenue Code of 1986, as amended to date ("Code").

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, when viewed together, are properly characterized as a sale or exchange of property, then such transfers shall be treated either as a transaction occurring between the partnership and one who is not a partner or as a transaction between two or more partners acting other than in their capacity as members of the partnership. The provision encompasses both disguised sales of property between a partner and a partnership and disguised sales of partnership interests (or other property) between partners.[5]

Although regulations under Section 731[6] already provided that substance, rather than form, should determine whether a transaction between a partnership and one or more partners should be characterized as a sale or exchange rather than a tax-free contribution and distribution of property, Congress believed that case law effectively permitted

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5 S. Prt. No. 169, 98th Cong., 2d Sess. 225 (1984) ("1984 Senate Report"). Both the language of the statute and the legislative history support the authority of the Treasury to issue regulations governing disguised sales of partnership interests. For example, the legislative history expresses concern 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." Id. (emphasis added).

6 From 1956 through today, the regulations under Section 731 have provided that (i) if there is a contribution of property to a partnership and within a short period the contributed property is distributed to another partner the distribution may not fall within the scope of section 731, and (ii) 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 partners. Treas. Reg. § 1.731-1(c)(3).

partners to defer or avoid tax on partnership transactions that were "economically indistinguishable from a sale of all or part of the property."[7] The potential for deferral arises from the fact that a partner receiving a cash distribution is generally permitted to recover the full amount of basis in his partnership interest before recognizing gain on the distribution,[8] whereas a partner selling a portion of his partnership interest is permitted to recover only a pro rata portion of his basis before recognizing gain.[9]

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7 *Id.* (citing *Communications Satellite Corp. v. U.S.*, 223 Ct. Cl. 253 (1980) and *Jupiter Corp. v. U.S.*, No. 83-842 (Ct. Cl. 1983)). In *Communications Satellite*. the Court of Claims considered a partnership in which partners admitted subsequent to an initial period paid for partnership interests pursuant to a formula, the effect of which was "to place each new partner in essentially the same position with respect to capital contributions and profits distributions as if it had been a member from the beginning." Any payment received from a new partner was distributed to the existing partners to reflect the reduction in their interests in the partnership. The court concluded that the transactions should be respected as contributions to and distributions by the partnership, rather than disguised sales of partnership interests. In *Jupiter*, the 77.5% general partner of a partnership agreed to admit a new 20% limited partner and to reduce its own interest to 57.5%. Shortly following the amendment of the partnership agreement to reflect these changes, an amount equal to the capital contribution of the new limited partner was distributed to the general partner. The Court of Claims again held that the contribution to and distribution from the partnership would be respected as such and not recharacterized as a sale of a partnership interest.

8 *See* Section 731.

9 Under Rev. Rul. 84-53, 1984-1 C.B. 159, the adjusted basis of the transferred portion of a partnership interest generally equals the sum of (A) the amount of partnership liabilities that is considered discharged on the disposition, plus (B) the adjusted basis of the entire partnership interest (excluding any basis attributable to partnership liabilities), multiplied by the value of the transferred portion of the partnership interest, divided by the value of the entire partnership interest. In cases where the partner's share of partnership liabilities exceeds the partner's adjusted basis in the entire partnership interest, the adjusted basis of the transferred portion is equal the

> Example 1: A and B are equal partners of a partnership that has no liabilities. A's tax basis in his partnership interest is $60 and A's partnership interest is worth $100. If A sells B 50% of A's partnership interest for $50, A will recognize $20 of gain ($50 amount realized less $30 of recovered tax basis). However, if B contributes $50 to the partnership and the partnership distributes the $50 to A (and the form of the transaction is respected), A will not recognize any gain on the receipt of the $50. A's basis in the remaining portion of his partnership interest will be $10, deferring (but not eliminating) the $40 of built-in gain.

The recharacterization of a contribution and distribution as a disguised sale of a partnership interest can have significant tax consequences beyond deferral of gain. For example, if a contribution and distribution are rechacterized as a disguised sale of a partnership interest:

Distributee Partner: To the extent the partnership holds "hot assets" the transfer will be governed by Section 751(a) rather than Section 751(b).

Contributing Partner: The interest acquired by the contributing partner will include a portion of the Section 704(c) attributes of the distributee partner's partnership interest, reverse Section 704(c) principles will not apply with respect to the interest, and (if a Section 754 election is in effect) adjustments will be made pursuant to Section 743 rather than 734.

Other Partners: Sections 734 and 736 will not apply with respect to the distribution, and the disguised sale could give rise to a termination under Section 708(b).

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adjusted basis of the entire partnership interest (including basis attributable to partnership liabilities), multiplied by the amount of partnership liabilities that is considered discharged on the disposition, divided by the partner's share of all the partnership liabilities (pre transfer).

Section 707(a)(2)(B) was enacted as part of the Deficit Reduction Act of 1984. In 1985, we submitted a report setting forth recommendations concerning the proposed regulations to be issued under Section 704(c), 707(a)(2) and 752.[10] In 1991, the Treasury issued proposed regulations covering disguised sales of property between partners and partnerships and we submitted a report commenting on these regulations.[11] In 1992, final regulations were issued (the "Existing 707 Regulations").[12] The regulations under Section 707 reserve on the issue of disguised sales of partnership interests.[13]

3. General Objectives in Drafting the New Regulations

The first and most obvious objective in drafting the New Regulations is to reflect the legislative history to Section 707(a)(2)(B). Although most of the legislative history does not relate directly to disguised sales of partnership interests, it is fairly clear that Congress intended Section 707(a)(2)(B) to apply in potentially abusive situations (*i.e.*, to

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[10] *See* New York State Bar Association, Tax Section, Committee on Partnerships, "Comments Relating to Proposed Regulations to be Issued Pursuant to Sections 704(c), 707(a)(2) and 752" (May 7, 1985). A relatively small portion of that report is devoted to disguised sales of partnership interests. Specifically, we recommended that a transaction should not be treated as a disguised sale of a partnership interest (i) unless there is an actual contribution and an actual distribution (as opposed to a deemed contribution and distribution under section 752) or (ii) if the underlying distribution is made in liquidation of a deceased or retired partner's interest, which is generally governed by section 736. *See id.*, Section II.B.3.

[11] *See* New York State Bar Association, Tax Section, "Report on Proposed Section 707 Regulations Concerning Disguised Sales of Property Through Partnerships" (October 25, 1991).

[12] *See* Treas. Regs. §§1.707-3, -4, -5 and -6.

[13] Treas. Reg. §1.707-7.

transactions that permit the deferral or avoidance of tax) involving partnership contributions and distributions that are, in substance, sales of property.[14] This intent is reflected in the statutory language of Section 707(a)(2)(B), which requires an analysis of "proper characterization," in addition to "relatedness," to find a disguised sale.[15] Congress also clearly sought to overturn the results in *Communications Satellite* and *Jupiter*.[16]

We recommend that when a transaction is characterized under the New Regulations as a disguised sale of a partnership interest, that treatment should, consistent with the Existing 707 Regulations,[17] apply for all purposes under the Code and Treasury regulations. Accordingly, the New Regulations will need to be coordinated with the existing rules of Subchapter K, including Section 708 (governing partnership

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[14] *See*, *e.g.*, 1984 Senate Report at 225 ("[T]he 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."); *id.* at 230 ("[T]he 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.").

[15] This element was not present in the original House version of the bill that became Section 707(a)(2)(B), but was added by the Senate to "explicitly limit the provision to cases in which a transfer of money or property to a partnership and a related transfer of money or property by the partnership are, when viewed together, properly characterized as a sale of property." H.R. Conf. Rpt. No. 861, 98th Cong., 2d Sess. 1639 (1984).

[16] See note 6.

[17] *See* Treas. Reg. §1.707-3(a)(3).

terminations), Section 736 (governing payments to retired partners), the more technical rules governing basis allocation upon partial sales of partnership interests[18] and the holding period rules applicable upon sales of partnership interests,[19] as well as the provisions of the Existing 707 Regulations dealing with disguised sales of property other than partnership interests. Thus, for example, we recommend that, in order to facilitate the application of the basis allocation rules applicable to the sale of part of a partnership interest, the New Regulations provide guidance as to what portion of a partner's interest in a partnership will be treated as sold when a disguised sale is found.[20]

4. Recommended General Rule

We recommend that the New Regulations adopt the same basic framework used in the Existing 707 Regulations. In determining whether a disguised sale has occurred, the New Regulations should adopt a general "facts and circumstances" approach, subject to appropriate presumptions and safe harbors to provide a reasonable degree of certainty in certain situations. This approach reflects the view that not every transaction that could have been structured as a sale of a partnership interest should be treated as such, and is consistent with the desire of Congress to target "transactions that attempt to disguise a sale of property" as opposed to "non-abusive transactions that reflect the various

[18] *See* Rev. Rul. 84-53, 1984-1 C.B. 159.

[19] *See* Treas. Reg. §1.1223-3.

[20] See part 7, below.

economic contributions of the partners."[21] We believe this is an appropriate framework because it is flexible in its application and enables the regulations to cover a wide range of potential transactions without an overly broad set of mechanical provisions.

Under the Existing 707 Regulations, a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale of property by the partner to the partnership only if based on all the facts and circumstances: (i) the transfer of money or other consideration would not have been made but for the transfer of property (referred to herein as the "but for" test) and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.[22]

Differences from Existing 707 Regulations

The New Regulations should reflect the important differences between transactions that might be characterized as a disguised sale of property between a partner and a partnership under the Existing 707 Regulations and transactions that might be characterized as a disguised sale of a partnership interest between partners under the New Regulations. Specifically, in a potential disguised sale of property between a partner and a partnership, the two parties to the potential disguised sale are also direct parties to both

[21] 1984 Senate Report at 230.

[22] *See* Treas. Reg. §1.707-3(a), (b).

of the actual transactions (*i.e.*, the transfer of property by the partner to the partnership and the transfer of property from the partnership to the same partner). The two transactions necessarily bear some relation to each other, and the parties therefore generally have all of the facts needed to determine whether their transactions should be characterized as a disguised sale. By contrast, the relationship between the two parts of a potential disguised sale of partnership interests can be much less direct. In some cases, the contributing partner may not know (or care, absent potential disguised sale treatment) that another partner is receiving a distribution, and in other cases the distributee partner may not know (or care) that a new or existing partner is making a contribution.

Moreover, the Existing 707 Regulations are potentially applicable only in cases where there are contributions or distributions of non-cash property. In most partnerships this is a fairly uncommon event. By contrast, the rules governing disguised sales of partnership interests will presumably be potentially applicable whenever there are cash contributions and cash distributions--which are common events in most partnerships.

In light of these differences, we believe that the test for finding a disguised sale of a partnership interest under the New Regulations should be narrower than the test for finding a disguised sale of property to or from a partnership under the Existing 707 Regulations. In particular, we recommend that, in addition to the basic prerequisites to the finding of a disguised sale under the Existing 707 Regulations noted above, the New Regulations provide that a contribution and distribution will give rise to a disguised sale of a partnership interest only if the two transfers are "directly related." In some cases, the normal operation of the partnership agreement may provide a sufficient direct connection (*e.g.*, where a partnership agreement provides that, upon receipt of a contribution from a new partner, a corresponding amount is required to be distributed *pro rata* to the existing partners).[23] In other cases (*e.g.*, where the partnership agreement grants the general partner the right to admit additional partners and the existing partners the right to be redeemed), the partnership agreement (without more) may not provide a sufficient connection.

Although the "but for" test applicable under the Existing 707 Regulations may appear to require a sufficient connection, we believe that the indirect nature of disguised sales of partnership interests and the fact that cash contributions and distributions are ordinary events for most partnerships necessitates that there be a direct connection between the two transfers beyond the mere fact that the distribution may not have been made "but for" the contribution. Under the "directly related" test, contributions and distributions which merely reflect (or give effect to) the original economic deal between a partner and a partnership and which are not intended to effect a transfer between partners will not serve as the predicate for a disguised sale of a partnership interest.[24]

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23 These were essentially the facts in *Communications Satellite.* See note 6, above.

24 Notwithstanding the addition of the "directly related" test, we recommend that the New Regulations retain the "but for" test. This requirement is as appropriate in the case of disguised sale of a partnership interests as it is under the Existing 707 Regulations (that is, disguised sale treatment should not apply under the New Regulations unless the distribution would not have been made but for the

General Rule

We would propose the following general rule (based in part on the general rule applicable under the Existing 707 Regulations) for determining whether a partnership contribution and distribution should be treated as a disguised sale of a partnership interest:

> A transfer of money or property by a partnership (a "<u>redeeming distribution</u>") to a partner (the "<u>distributee partner</u>") and a transfer of money or property by a new or existing partner (the "<u>contributing partner</u>") to a partnership (an "<u>acquiring contribution</u>") constitute a sale of an interest in the partnership by the distributee partner to the contributing partner only if, based on all the facts and circumstances, (<u>i</u>) the transfer to the distributee partner would not have been made but for the transfer by the contributing partner, (<u>ii</u>) in cases where the redeeming distribution and the acquiring contribution are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risk of partnership operations and (<u>iii</u>) the redeeming distribution and the acquiring contribution are directly related.

Facts and Circumstances

Consistent with the Existing 707 Regulations, the determination of whether a redeeming distribution and an acquiring contribution constitute a sale, in whole or in part, under the general rule should be based on all the facts and circumstances existing on the date of the earlier of such transfers. Among the facts and circumstances that may tend to prove the existence of a sale under the general rule are the following:

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contribution). Moreover, retaining the "but for" test provides a relatively bright line rule and furthers the consistency between the New Regulations and the Existing 707 Regulations.

(1) That the partnership interest resulting from the acquiring contribution is substantially similar to the partnership interest reduced or eliminated as a result of the redeeming distribution;

(2) That the acquiring contribution(s) was made by a single contributing partner or was otherwise not made pro rata by the existing partners (other than the distributee partner);

(3) That pursuant to the partnership agreement (or a plan or arrangement to which the contributing partner or the distributee partner is a party), the distribution is contingent upon the contribution or the contribution is dependent upon the distribution;

(4) In cases where the acquiring contribution is in the form of non-cash property, that the same property is used to effect the redeeming distribution;

(5) That the distributee partner is aware of the acquiring contribution;

(6) That the contributing partner is aware of the redeeming distribution;

(7) That there were negotiations between the distributee partner and the contributing partner (or between the partnership and each of the contributing partner and the distributee partner and of which each partner was aware) concerning either transfer;

(8) That the distributee partner and the contributing partner enter into one or more agreements, including an amendment to the partnership agreement (other than an amendment for the purpose of admitting the contributing partner) relating to the transfers (*e.g.*, an agreement whereby the distributee partner provides representations, warranties or an indemnity concerning the partnership to the contributing partner);

(9) That the transfer to the distributee partner was disproportionate to the transfers made by the partnership to the other partners holding the same class of interest;

(10) That the transfer by the contributing partner was disproportionate to the transfers made by the other partners to the partnership holding the same class of interest;

(11) That the distributee partner had the ability to prevent the transfer by the contributing partner;

(12) That the redeeming distribution was an extraordinary distribution or the acquiring contribution was an extraordinary contribution;[25]

(13) That the timing and amount of all (or any portion) of the subsequent transfer are determinable with reasonable certainty at the time of the earlier transfer; and

(14) That there is a legally enforceable right of the person receiving the subsequent transfer to receive such transfer and that such right is secured in any manner, taking into account the period during which it is secured.

This overall facts and circumstances approach follows the approach taken by the Existing 707 Regulations. Other facts and circumstances may tend to prove the absence of a disguised sale (*e.g.*, the fact that the distribution or contribution was not within the control of the distributee partner or the contributing partner). However, in order to preserve consistency with the Existing 707 Regulations and to preserve relative simplicity, we recommend that New Regulations not delineate "negative" facts and circumstances.

Treatment of Partnership Liabilities In General

Any shift in the sharing of partnership liabilities is likely to produce deemed contributions and distributions occurring at similar times and in similar amounts under Section 752. However, these deemed contributions and distributions typically do not

[25] The regulations would need to provide some guidance on what constitutes an extraordinary contribution or distribution. As reflected in the examples below, we would recommend that the following transactions not be considered extraordinary for this purpose: (i) an acquiring contribution required to be made as a result of a default by another partner or to cure a default, (ii) an acquiring contribution made to fund a service partner's prescribed share of working capital, and (iii) a redeeming distribution made as a result of an overfunding of a service partner's prescribed share of working capital.

affect a partner's interest in partnership capital or profits and therefore generally should not, standing alone, provide the requisite "acquiring contribution" and "redeeming distribution" necessary to find a disguised sale of a partnership interest under the general rule. Accordingly, we recommend that deemed contributions and distributions under Section 752 resulting from the incurrence or discharge of partnership liabilities or any changes in the apportionment of such liabilities generally be disregarded in determining whether there has been a disguised sale of a partnership interest. However, if a disguised sale is found without regard to such liabilities, the amount of such liabilities should be taken into account in determining the amount realized on such sale under normal Subchapter K principles.

This approach would comport with the treatment of qualified liabilities under the Existing 707 Regulations[26] and the treatment of liabilities under the rules for determining the holding period of a partnership interest.[27] In addition, it would be consistent with the intent expressed in the legislative history to Section 707(a)(2) that the regulations "take into account the effect of liabilities which may accompany effective sales of property to a partnership or another partner."[28]

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[26] *See* Treas. Reg. §1.707-5(a)(5).

[27] *See* Treas. Reg. §1.1223-3(b)(3).

[28] 1984 Senate Report at 231.

The following examples illustrate the general application of these recommendations with respect to partnership liabilities:

> Example 2: A, B and C are equal partners of a partnership. The partnership has \$60 of partnership non-recourse debt, which is allocated equally among A, B and C. D makes a contribution to the partnership. Pursuant to the normal operation of the partnership agreement and Section 752, D is allocated \$15 of the partnership debt and the partnership debt allocated to each of A, B and C is reduced by \$5.
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> Although there has been an acquiring contribution (the contribution by D), there has not been a redeeming distribution because the \$5 deemed distribution to each of A, B and C is disregarded for purposes of determining whether there has been a deemed distribution. Accordingly, there has been no disguised sale.
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> Example 3: A, B and C are equal partners of a partnership. The partnership has \$60 of partnership non-recourse debt, which is allocated equally among A, B and C. In response to a request from A to reduce his interest the partnership, the partnership makes a \$10 distribution to A. Pursuant to the normal operation of the partnership agreement and Section 752, A's share of the partnership debt is reduced by \$10 and each of B's and C's share of the liability is increased by \$5.
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> Although there has been a redeeming distribution (the \$10 actual cash transfer to A), there has not been an acquiring contribution because the \$5 deemed contribution by each of B and C is disregarded for purposes of determining whether there has been an acquiring contribution. Accordingly, there has been no disguised sale.

Treatment of Partnership Liabilities In Certain Cases – Anti-Abuse Considerations

There are clearly instances where partnership liabilities can be used to effect transactions that closely resemble disguised sales of partnership interests. For example, where a partnership incurs a liability to effect a distribution, the liability is structured so that the assets of a particular partner (directly or indirectly) provide the primary credit support for the liability, and that partner's sharing of profits and losses are increased by an amount that corresponds to the reduction in the sharing by the distributee partner, the transaction can clearly resemble a disguised sale of all or a portion of the distributee partner's partnership interest. Consider the following examples, which under the general rule proposed above would not give rise to a disguised sale but, nonetheless, we believe Examples 4, 5 and 7 should give rise to a disguised sale. Accordingly, we propose, below, an anti-abuse rule:

> <u>Example 4</u>: A, B and C are (in general) equal partners of a partnership that has no liabilities and has assets in excess of $1000. With respect to a particular partnership asset (Asset A), there is a special sharing arrangement that entitles A to 95% and B to 5% of any income generated by Asset A, including any proceeds derived from a sale of Asset A. Asset A has a value of $100. The partnership borrows $50 from a third-party bank. The only recourse of the lender is to Asset A. The partnership uses the $50 to make a $50 distribution to C which reduces C's interest in profits and capital. As part of the overall transaction, the partnership agreement is amended to increase A's and B's general interest in profits by a similar amount. Assume that under Section 752, the partnership liability is allocable 95% to A and 5% to B.
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> <u>Example 5</u>: A and B are equal partners of a partnership that has no liabilities and has assets in excess of $100. A transfers a 1% partnership interest to its wholly-owned subsidiary. Immediately thereafter, a third party loans $50 on a nonrecourse basis to the partnership, which uses the money to make a liquidating distribution to B. No amendment to the terms of the partnership agreement is made in connection with the transactions.
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> <u>Example 6</u>: A, B, C, D and E are equal partners of a partnership that has no liabilities and has assets worth $1000. A third party loans $200 to the partnership and the partnership uses the $200 to make a liquidating distribution to B. A guarantees the loan. However, no amendment to the partnership agreement is made in connection with the transactions and, under the original partnership agreement, the guarantee by A has no effect on the sharing of partnership income. As a result, A, C, D and E remain equal partners.
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> <u>Example 7</u>: Same as Example 6, except that in connection with the guarantee and the reduction in B's interest, A's interest in partnership profits is increased by an amount that corresponds with the reduction in B's share of partnership profits.

Under our proposed general rule for partnership liabilities discussed above, the transactions described in Examples 4-7 would not give rise to a disguised sale because the only transfer to the partnership is a deemed contribution arising under Section 752 and such deemed contributions (standing alone) generally would not serve as the predicate for a disguised sale. This result seems appropriate in Example 6 since A's interest in the partnership was not increased any more than the other remaining partners by virtue of the redemption of B's interest. However, disguised sale treatment could clearly be justified in the other examples since A's interest in the partnership has increased by an amount that approximates the reduction in other partners' interests. Disguised sale treatment is in certain respects even more appropriate in Examples 4 and 5 since in those cases A is the only partner economically at risk (or substantially at risk) for the liability.

In light of the issues raised by these examples, we recommend that the New Regulations contain an anti-abuse exception to the general rule that deemed contributions and distributions under Section 752 should be ignored in determining whether there has been a disguised sale. Since partnership operations routinely involve the incurrence and discharge of liabilities, we believe it is important for the exception to be narrowly defined to address identified cases where disguised sale treatment is considered appropriate. Accordingly, we recommend that the anti-abuse rule apply only to the types of transactions described above (*i.e.*, cases where a partnership incurs a liability to effect a distribution, the liability is structured so that the assets of a particular partner, directly or indirectly, provide the primary credit support for the liability, and that partner's sharing of profits and losses is increased by an amount that corresponds to the reduction in the sharing by the distributee partner) and any other specific transactions identified by the Treasury.

Loans by a Partner to a Partnership

If a partner loans money to a partnership and the proceeds are distributed to another partner, there is an actual transfer of cash to the partnership and an actual distribution. As a result, disguised sale treatment is potentially applicable without resort to any deemed contributions arising under Section 752. However, from a disguised sale perspective, a loan by a partner is typically not materially different from a third-party loan that is either guaranteed by a particular partner or that is otherwise adequately secured by partnership assets. Moreover, a disguised sale of a partnership interest necessarily involves a transaction whereby one person's partnership interest is created or increased by an amount corresponding to the reduction in another person's partnership interest. When a distribution by a partnership is funded by a loan from another partner rather than an equity contribution by a partner, disguised sale treatment seems inappropriate since partnership debt was acquired rather than a partnership interest. Accordingly, we recommend that the New Regulations generally provide that a cash transfer to a partnership made in the form of a loan generally will not be treated as an acquiring contribution and therefore generally will not serve as the predicate for a disguised sale. However, we believe the anti-abuse exception discussed above should extend to redeeming distributions funded with partner-funded debt.

> Example 8: A, B, C, D and E are equal partners of a partnership that has no liabilities and has assets worth $1000. A loans $200 to the partnership and the partnership uses the $200 to make a liquidating distribution to B. However, no amendment to the partnership agreement is made in connection with the transactions and, under the original partnership agreement, the loan by A has no effect on the sharing of partnership income or losses. As a result, A, C, D and E remain equal partners. Under the proposed rule, the loan by A to the partnership and the related distribution to B are not treated as a disguised sale of B's partnership interest to A.

5. Other Presumptions and Safe Harbors

Two-Year Presumptions

Consistent with the Existing 707 Regulations, the New Regulations should provide for a presumption against disguised sale treatment in cases where the redeeming distribution and the acquiring contribution are more than two years apart and, in certain cases, a presumption in favor of a disguised sale where the redeeming distribution and the acquiring contribution occur within two years (unless a contrary presumption or safe harbor applies). The indirect nature of disguised sales of partnership interests arguably supports a period shorter than two years for purposes of these presumptions. However, we believe that there is a benefit to consistency with the Existing 707 Regulations and, assuming our recommended general rule, presumptions and safe harbors are adopted, taxpayers should be adequately protected against overly broad application of the disguised sale rules.

However, we recommend that the two-year presumption in favor of disguised sale treatment apply only where there is some kind of "extraordinary" contribution or distribution. This limitation would generally be consistent with the Existing 707 Regulations in that those regulations only apply if there is a non-cash transfer to or from the partnership and non-cash contributions and distributions are fairly uncommon in most partnerships. Having a two-year presumption in favor of treatment as a disguised sale of a partnership interest whenever there is a cash contribution or cash distribution seems unworkable since many, if not most, partnerships routinely (sometimes monthly) make cash distributions and routinely receive cash contributions. These routine transfers reflect the normal operation of the partnership and ordinarily should not give rise to disguised sale treatment. As a result, it would be anomalous if all such transfers within a two-year window created a presumption in favor of disguised sale treatment. Accordingly, we recommend that the two-year presumption only apply to extraordinary distributions.[29]

Guaranteed Payments, Preferred Returns and Operating Cash Flow Distributions

The Existing 707 Regulations generally provide that amounts received as certain guaranteed payments, preferred returns or operating cash flow distributions are not treated as (or are presumed not to be) part of a sale of property to a partnership.[30] Rights to these types of payments are essentially treated as equity rights under the Existing 707

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29 See note 23 (discussing certain examples of extraordinary distribution).

30 *See* Treas. Reg. § 1.707-4.

Regulations. As a result, these types of payments are generally treated as having been received pursuant to a partnership distribution rather than pursuant to a disguised sale to the partnership. We believe that the New Regulations should similarly treat rights to these types of payments as a continuing equity interest in the partnership so that cash transfers made pursuant to these types of provisions would generally not be treated as redeeming distributions and thus generally would not serve as the predicate for disguised sales of partnership interests. This would harmonize the New Regulations with an important aspect of the Existing 707 Regulations and would reflect the fact that Congress did not intend to prohibit a partner from contributing property for a partnership interest which entitles him to priorities or preferences as to distributions or ordinary distributions of operating income, if the transaction is not in substance a disguised sale.[31] These types of distributions should generally be excluded even if they are added to the partnership agreement in connection with the contribution to the partnership.[32]

Funding of Another Partner's Capital

Partnership agreements sometimes provide that if one partner defaults on an obligation to make a capital contribution, the shortfall will be made up by the other

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31 Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84, at 232 (1985).

32 Under the Existing 707 Regulations, reasonable guaranteed payments never give rise to a disguised sale whereas reasonable preferred returns and operating cash flow distributions are presumed not to give rise to a disguised sale. We recommend that the New Regulations follow this basic approach.

partners and that, upon a cure of the shortfall by the defaulting partner, the partners who overfunded will receive a return of their excess contributions. Although the transfers by the overfunding partners resemble, in certain respects, a loan to the partnership or the defaulting partner, non-tax considerations often prevent the partners and the partnership from effecting the transaction as a loan. The subsequent transfer by the defaulting partner to the partnership and the related transfers by the partnership to the overfunding partners merely restore the original economic deal between each partner and the partnership concerning the amount of required capital and therefore generally should not be characterized as a sale by the overfunding partners of a portion of the partnership interest to the defaulting partner. As a result of the basis allocation rules applicable to partial sales of partnership interest, a portion of the cash transferred back to the overfunding partners could result in their recognizing gain, even though when viewed as a whole there has not been an economic gain to them from the transaction and the distribution in substance reflects a return of capital. We believe that it would therefore be appropriate and helpful for the New Regulations to adopt a safe harbor providing that disguised sale treatment will not result under these circumstances.

> Example 9: A, B and C have each committed to contribute 33-1/3% of the capital required by Partnership (up to a specified cap). In year 1, A, B and C each contribute $100 to the partnership. In year 2 (when there is $300 of unrealized appreciation), the partnership calls for an additional $100 of capital from each partner. Although A and B each contribute $100 to the partnership, C defaults initially and does not contribute the $100 as required by the partnership agreement. As a result of C's default, A and B are each required to contribute an additional $50 to the partnership. One month later, pursuant to the terms of the partnership agreement, C cures the default by contributing $100 to the partnership and the partnership distributes the $50 to each of A and B. The $100 contribution

made by C to cure its default and the related distribution of that $100 to A and B are not treated as a disguised sale as a result of the application of the safe harbor.[33]

Liquidating Distributions

The deferral of gain which Section 707(a)(2)(B) was principally intended to prevent is typically not present in cases where a partner receives a cash distribution in liquidation of its entire partnership interest.[34] As a result, we considered whether liquidating distributions should be excluded from the rules governing disguised sales of partnership interest. Such an exclusion would provide a bright line rule that would exempt a large category of non-abusive transactions. However, two factors lead us not to recommend that liquidating distributions be excluded. First, while deferral was apparently the principal abuse Section 707(a)(2)(B) was intended to prevent, it is not the

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33 Note that if disguised sale treatment applied, A and B would be treated as having sold 50/350ths of its partnership interest to C for $50x. A's and B's respective basis in the portion sold would equal $35.71 (5/35ths of $250) and therefore A and B would recognize gain of $14.29 ($50x-$35.71). This result appears unwarranted given the substance of the transaction.

34 Liquidating distributions are governed by Section 736(a) and/or Section 736(b). In the case of a Section 736(a) distribution, the distribution is treated as a distributive share or guaranteed payment. In the case of a Section 736(b) distribution, the payment is treated as a distribution governed by the more general rules of Sections 731 and 751(b). Accordingly, cash received in excess of the partner's basis results in capital gain, except to the extent the payment is attributable to partner's share of the partnership's "hot assets". In general, liquidating distributions are governed by Section 736(b) to the extent that they are considered to made in exchange for an interest in partnership property (including goodwill). However, Section 736(b)(2)(B) generally provides that, unless the partnership otherwise specifies, payments to a general partner from a partnership in which capital is not a material income-producing factor for the goodwill of the partnership are governed by Section 736(a).

only concern that can arise when related contributions and distributions are taxed in accordance with their form rather than their substance. For example, if liquidating distributions (and related contributions) were always taxed in accordance with their form, parties could effectively avoid terminations under Section 708(b)(1)(B). Under Section 708(b)(1)(B), a partnership is considered terminated if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. The primary substantive consequence of such a termination is that the partnership is required to reset the applicable period for depreciation of tangible property under Section 168.[35] Interests acquired by contributions to the partnership and interests redeemed by distributions from the partnership are not treated as interests that were sold or exchanged for purposes of the 50% test, assuming that the contributions and distributions are respected as such and not treated as part of a disguised sale.[36] Accordingly, a safe harbor that exempted all liquidating distributions from disguised sale treatment would make it relatively easy in many cases for well-advised taxpayers to avoid Section 708(b)(1)(B) and the resulting effect under Section 168. Second, the fact that a distribution is in liquidation of a partner's interest in a partnership does not preclude the distribution from being viewed, in substance, as part of a disguised sale of an interest to another partner who made a contribution to the partnership in order to fund the liquidating distribution. Thus, even in partnerships where Section 708(b)

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35 *See* Section 168(i)(7).

36 *See* Treas. Reg. §1.708-1(b)(2).

terminations are relatively unimportant because there is little depreciable property, we believe that liquidating distributions should not be exempted under the New Regulations.

6. Examples

Because of the potential uncertainties that may be created by a general facts and circumstances test for disguised sale treatment, it would be appropriate and helpful for the New Regulations to include a number of examples illustrating the application of the general rule to certain common partnership transactions. This would allow taxpayers to better understand the operation of the rule and to take comfort that certain transactions ordinarily will not give rise to a disguised sale under the New Regulations.

Regular Distributions

We recommend that the New Regulations include examples illustrating that cash distributions made pursuant to the routine application of the provisions of the partnership agreement governing distributions of partnership profits or operating cash flow ordinarily will not give rise to a disguised sale. These distributions reflect the normal operation of the partnership rather than a transaction that constitutes, in substance, a sale between two partners. Accordingly, we recommend the inclusion of examples similar to the following:

> <u>Example 10</u>: Partnership agreement provides that all net profits shall be distributed at such times and in such amounts as shall be determined by the general partner but that all such distributions shall be made among the partners pursuant to a defined formula. In September, the partnership admits a new

partner who makes a capital contribution of $10. In December, the partnership distributes $10 pursuant to the above-described distribution formula out of accumulated net profit. The amount of the distribution is reasonably consistent with other distributions of net profits previously made or expected to be made. Under the general rule, the contribution and distribution are not treated as a disguised sale of a partnership interest.

Example 11: A, B and C are limited partners of HF partnership. Profits (realized and unrealized) of HF partnership are generally allocated 20% to the general partner and 80% to the limited partners. Under the partnership agreement, at the end of each quarter any limited partner may require the partnership to make a distribution to that partner of all or part of his capital account balance if the partnership has sufficient cash to make the distribution. The partnership agreement also provides that the partnership may admit additional partners as of the end of each quarter. Partners regularly receive distributions pursuant to the distribution provision without regard to whether there is a corresponding contribution. At the end of a quarter, D is admitted to the Partnership and makes a $10 contribution, and A requests and receives a $10 distribution. Prior to D's admission, the partnership had $10 of available cash that could be used to fund the $10 distribution to A. The contribution and distribution are not treated as a disguised sale of a partnership interest because the distribution would have been made even if the contribution had not been made.

Example 12: Same as Example 11 except that, prior to D's admission, the partnership did not have any cash available to fund the distribution to A. Although the distribution to A would not have been made but for the contribution by D, the contribution and distribution are not treated as a disguised sale of a partnership interest because the distribution and the contribution are not directly related.

Contributions and Distributions of Working Capital in Service Partnerships

Service partners in a professional service partnership typically do not sell interests in the partnership to other service partners through an ordinary sale transaction. However, service partners regularly make capital contributions to the partnership to fund working capital and regularly receive distributions from the partnership. It is quite common in the professional service context for a new partner to be required upon admission to the partnership to make a cash contribution equal to his or her share of the partnership's working capital and for the partner's share of the working capital to increase as the partner becomes more senior. As a result, the partner is frequently required to make additional capital contributions to the partnership over time in respect of the working capital. In many cases, the receipt of the capital results in an overfunding of the partnership's working capital and often this working capital is distributed to more senior partners whose proportionate share of the partnership's working capital is declining (whether as they approach retirement age or upon retirement). Although the contributions and related distributions could be viewed as a disguised sale of a partnership interest by the senior partners to the junior partner,[37] the parties typically do not view the transfers in this manner. Rather, the contributions and distributions reflect (and give effect to) the original economic deal between the relevant partner and the partnership concerning the partner's required share of working capital. Accordingly, we recommend that the New Regulations include an example clarifying that contributions and distributions in respect of a service partner's share of working capital will not give rise to a disguised sale under the general rule.

Contributions of Non-Cash Property

It is common for a new or existing partner to transfer in-kind property to a partnership in exchange for a partnership interest. We expect that, in the vast majority of

[37] Although the partner does not really have economic gain in respect of the working capital, the receipt of the working capital distribution could give rise to a taxable gain to the partner as a result of the application of the basis allocation rules if the distribution were treated as part of disguised sale the partner's partnership interest.

cases, these transfers will not be directly related to any redeeming distribution and therefore will not give rise to disguised sale treatment under the New Regulations. However, in light of the frequency of these transactions and the importance (in many cases) of tax free treatment to the person contributing the property, it would be appropriate and helpful for the New Regulations to confirm (either by way of an example or additional safe harbor) that such transfers will not serve as a predicate to disguised sale treatment under the New Regulations so long as (i) the transferred property will be used or held by the partnership and (ii) avoiding disguised sale treatment was not a principal purposes of the transfer of the property to the partnership.

> Example 13: Partnership XYZ is engaged in a manufacturing business. Existing partner X contributes to XYZ a machine worth $500 that will be used in XYZ's business, and X's sharing of profits and losses is increased to reflect the value of the contribution. Concurrently with X's contribution, partner Y receives a cash distribution of $500 in partial redemption of Y's partnership interest. Avoiding disguised sale treatment was not a principal purposes of the transfer of the machine to the partnership. The contribution and distribution are not treated as a disguised sale of a partnership interest.

Cases Referred to in the Legislative History of Section 707(a)(2)(B)

In light of the Congressional intent to overrule the results of *Communications Satellite* and *Jupiter*,[38] we recommend that the New Regulations provide examples clarifying that the situations at issue in those cases will be treated as disguised sales of partnership interests under the New Regulations. Possible examples follow:

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[38] See note 6, supra.

Example 14: On January 1, 2002, A, B and C are admitted as limited partners to partnership. A, B and C each commit to contribute $1000 to partnership over its term. On January 30, 2002, A, B and C each contribute $100 to the partnership to permit it to acquire an investment. On March 31, 2002, D is admitted to the partnership and also has a $1000 commitment. Pursuant to the terms of the partnership, at the time of D's admission as a partner, D is required to contribute $75 (plus an interest factor) to the partnership and the partnership is required to distribute this amount among A, B and C. The contribution and distribution are treated as a disguised sale by each of A, B and C of a portion of their respective partnership interests to D in exchange for the amount of the distribution received.

Example 15: JV partnership is owned 77.5% by A, its general partner, and 22.5% by B, a limited partner. C contributes cash to JV partnership and, in connection with the contribution, the partnership agreement is amended to admit C as a 20% limited partner and reduce A's general partner interest to 57.5%. Shortly thereafter, JV partnership distributes to A an amount equivalent to that contributed by C. The contribution, amendment and distribution are treated as (i) the conversion by A of a 20% general partner interest into a 20% limited partner interest followed by (ii) the sale by A of its 20% limited partner interest in JV partnership to C in exchange for the amount of the distribution received by A.

Other Cases Finding Disguised Sale Treatment

It would also be appropriate and helpful for the New Regulations to provide general examples of transactions that ordinarily would be treated as disguised sales. One potential example is the following:

Example 16: A and B are equal partners in a partnership with substantial business assets. Under the terms of the partnership agreement, each partner is only entitled to receive current distributions of net profits. C expresses an interest in acquiring A's partnership interest. Pursuant to an agreement between A, C and the partnership, C makes a contribution to the partnership and the partnership uses the cash to make a liquidating distribution to A. Alternatively, assume that the distribution is made one year after the contribution. The contribution and distribution are presumed to be treated as a disguised sale of A's partnership interest to C.

7. Determining the Amount Sold

In the event that there is a disguised sale, the parties will need to compute the portions of contribution and distribution which are treated as part of that sale and the portions (if any) that are treated as regular contributions or distributions. For example, suppose that one partner contributes $7 to a partnership and another partner receives a $5 distribution from the partnership or, alternatively, that one partner contributes $5 to the partnership and another partner receives a $7 distribution from the partnership. In each case, it seems appropriate to provide that disguised sale treatment only applies to a $5 partnership interest. Accordingly, we recommend that the New Regulations provide that, in the case of a disguised sale, the contributing partner should be treated as having purchased, and the distributee partner should be treated as having sold, a partnership interest with a value equal to the lesser of (i) the amount of the acquiring contribution and (ii) the amount of the related redeeming distribution.

> Example 17: On Date 1, A and B each contribute $100 to partnership AB in exchange for a 50% interest. On Date 2, when the AB's assets are still worth $200, C contributes $65 to AB. Shortly thereafter, AB makes a $55 distribution to A that reduces A's proportionate share of profits and capital and that, together with C's contribution, is properly characterized as a disguised sale of a portion of A's partnership interest to C. The $10 balance of C's contribution is retained by AB. Following the contribution and distribution, AB is owned 45/210 by A, 100/210 by B and 65/210 by C. A is treated as having sold (and C is treated as having purchased) 55% of A's partnership interest for $55. In addition, C is treated as having made a $10 contribution to the partnership under Section 721.

> Example 18: The facts are the same as in Example 17, but C's contribution to AB is only $30. A is treated as having sold a partnership interest with a value of $30 and as having received a $25 distribution governed by Section 731.

We note that the amount of gain realized from a disguised sale of a partnership interest may be affected by a concurrent distribution. Assume, for example, that in

Example 18 the partnership's assets had increased in value to $300 such that the partnership interest held by each of A and B has a value of $150. If the $25 transfer that is treated as a distribution to A is viewed as preceding A's sale of a partnership interest worth $30, the distribution would reduce A's basis to $75, and A would be treated as selling 24% (or 30/125) of A's remaining partnership interest. A would recognize gain of $12 ($30 amount realized less $18 of basis ($30/$125 * $75)) and have remaining basis of $57 ($75-18). If the sale were treated as preceding the distribution, A would recognize gain of $10 ($30 amount realized less $20 of basis ($30/$150 * $100)) on the sale, and A's remaining basis of $80 ($100-$20) would be reduced to $55 upon the distribution of $25. We have not identified a principled basis for treating one of the two concurrent transactions as occurring first and therefore are not making a recommendation as to which transaction should be deemed to occur first. However, we do recommend that the New Regulations provide guidance on this issue.

The rules for determining the tax basis of a transferred partnership interest and the amount realized on the transfer further require the parties to identify the amount of discharged liabilities attributable to the transfer.[39] In transactions that are formally structured as sales, this is usually readily apparent. However, in the case of a disguised sale where the transfer from the partnership is treated in part as a disguised sale payment and in part as a regular distribution, it is appropriate to apportion any resulting liability

[39] *See* 1.1001-2(c) Example (3) and Rev. Rul. 84-53.

discharge between the payment and the distribution. While the portion attributable to the disguised sale payment would be included in amount realized and taken into account under the tax basis allocation rules, the portion attributable to the distribution would not but rather would be governed the normal rules applicable to partnership distributions. Accordingly, we recommend that the New Regulations further provide that the amount of liabilities treated as discharged upon a disguised sale should equal the lesser of (i) the amount of liabilities, if any, considered to be assumed by the contributing partner as a result of the acquiring contribution and (ii) the amount of liabilities, if any, of which the distributee partner is considered to be relieved as a result of the redeeming distribution.

8. Overlap Issue

Certain transactions could be treated as a disguised sale of an asset to a partnership under the Existing 707 Regulations or a disguised sale of a partnership interest pursuant to the New Regulations. For example, suppose that A is a member of an existing partnership and that (i) A contributes appreciated property to the partnership, (ii) B (an existing or new partner) contributes cash to the partnership and (iii) the partnership distributes the cash to A. The transaction could be viewed (a) under the Existing 707 Regulations as a contribution of cash by B followed by a disguised sale of the appreciated property by A to the partnership, (b) as a sale of the appreciated property by A to B followed by contribution of the appreciated property by B to the partnership, or (c) under the New Regulations as a contribution of the appreciated property by A to the partnership in exchange for a partnership interested followed by a disguised sale of a partnership interest by A to B. The legislative history of Section 707(a)(2)(B) discusses a similar transaction and suggests that the transaction is, in substance, a disguised sale of the contributed property (under either (a) or (b) above).[40] We believe that treatment under any of the three approaches may be justified and therefore we are not making a recommendation as to which treatment should prevail. However, we do recommend that the New Regulations provide guidance on this issue.

[40] *See* 1984 Senate Report at 225.