

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Disguised Sales of Partnership Interests

Responding to Reg-149519-03

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This report¹ responds to a Notice of Proposed Rulemaking (REG-149519-03) relating to the treatment of transactions between a partnership and its partners as disguised sales of partnership interests between the partners under section 707(a)(2)(B) of the Internal Revenue Code (the "Proposed Regulations"). We submitted our Report No. 1027 (the "2003 Report") in response to the Internal Revenue Service's request, in Notice 2001-64, 2001-1 C.B. 316, for comments on the scope and substance of proposed regulations relating to disguised sales of partnership interests. We are pleased at the thoughtful attention given to the 2003 Report and to the responses of other commentators in the preparation of the Proposed Regulations.

One of the major recommendations of the 2003 Report was that a "directly related" test, in addition to a "but for" test, should be applied in determining whether a transaction constitutes a disguised sale of a partnership interest. Although the Preamble accompanying the Proposed Regulations states, "The IRS and the Treasury Department agree that because many more transactions may potentially be subject to the proposed regulations [relating to disguised sales of partnership interests], it is appropriate that the proposed regulations be narrower than the existing regulations [relating to disguised sales of property between a partnership and a partner]," the Proposed Regulations did not adopt our recommendation that a disguised sale be found only when a "directly related" test was satisfied. Because we believe that

¹ This report was prepared by members of the Committees on Partnerships and Real Property of the Tax Section of the New York State Bar Association. The principal author was Elliot Pisem; substantial contributions were received from Jose Berra, Kimberly S. Blanchard, David Hariton, Janet Korins, Joel Scharfstein, David H. Schnabel and Jessica G. Weinberg; and helpful comments were received from Peter Canellos, Stephen Land, Charles Morgan, Deborah Paul and Steven Todrys.

a "but for" test may lead to inappropriate results in many ordinary cases and may treat as disguised sales nonabusive partnership contributions and distributions that ought not to be so recharacterized, we reiterate our view that a "directly related" test should be adopted.

1. Background

Section 707(a)(2)(B) of the Internal Revenue Code provides that, "under regulations prescribed by the Secretary," if a partner directly or indirectly transfers money or other property to a partnership, there is a related direct or indirect transfer of money or other property by the partnership to such partner or another partner, and these transfers are properly characterized as a sale or exchange of property, such partners will be treated as acting other than in their capacity as partners. The purpose of this provision was to prevent taxpayers from deferring or avoiding tax on the sale of partnership property, including partnership interests, by characterizing sales as contributions of property and distributions of property.² The legislative history of section 707(a)(2)(B) evidences the Congressional intent to distinguish between forms that "disguise" the "proper character" of a transaction, on the one hand, and "non-abusive" transactions that need not be recharacterized, on the other.³ Treasury Regulations³ regarding the disguised sale of property have been in effect since 1991. Section 1.707-7 of such Regulations was reserved for rules on disguised sales of partnership interests.

² See H.R. Rep. No. 861, 98th Cong., 2^d Sess. 861 (1984), 1984-3 (vol. 2) C.B. 115.

³ S. Pt. No. 169, 98th Cong., 2d Sess. 225, 230 (1984); H.R. Conf. Rpt. No. 861, 98th Cong., 2d Sess. 1639 (1984).

2. Summary of Recommendations

Our principal recommendations are:

a) A transfer of consideration by a purchasing partner to a partnership and a transfer of consideration by the partnership to a selling partner should constitute a sale of all or a portion of the selling partner's interest in the partnership to the purchasing partner only if, based on all the facts and circumstances, the two transfers are directly related.⁴ In determining whether or not transfers should be recharacterized, the absence of any reduction in the partnership interest of the partner receiving a transfer of consideration should be a strong, or perhaps dispositive, indication that no disguised sale of a partnership interest has occurred.

b) A disguised sale of a partnership interest should generally not be found in the case of a transfer of property, other than cash or marketable securities, by one partner to a partnership and a transfer by the partnership to another partner of other property not fungible with the property transferred to the partnership and, again, not consisting of cash or marketable securities.

c) The presumption that transfers made within two years of each other constitute a sale of all or a portion of the selling partner's interest in the partnership should be limited and should apply only if certain additional factual circumstances are present.

d) The proposed expansion of the disclosure rules of sections 1.707-3(c)(2) and 1.707-6(c)(1) to transfers occurring within a seven-year period, and of the disclosure rules of sections 1.707-5(a)(8) and 1.707-6(c)(3) where liabilities are assumed or taken subject to, should not be implemented. If it is determined, as stated in the Preamble to the Proposed Regulations,

⁴ As indicated in the 2003 Report, the directly related test would be added to the existing “but for” and “entrepreneurial risks” tests contained in the Proposed Regulations.

that "taxpayers are taking unwarranted positions regarding a partner's share of partnership liabilities," the substantive rules should be changed to prevent the taking of such positions.

e) Special rules should apply to staged closings that commonly occur in investment partnerships, and in light of the frequency in which such partnerships make non-liquidating but non-ordinary course distributions, special rules should apply to such partnerships generally.

f) In the case of nonsimultaneous transfers, a disguised sale of a partnership interest should not be treated as occurring on the date of the earliest of the transfers.

g) We have several suggestions for improving the working of the Proposed Regulations from a technical perspective.

3. Discussion

a) The Presumption of a Disguised Sale of a Partnership Interest Should Not Arise Unless Transfers Are Directly Related

Section 1.707-7(b)(1) of the Proposed Regulations states that 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 only if, based on all the facts and circumstances, 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. In cases in which the transfers are not made simultaneously, the transfers will not constitute a sale if the subsequent transfer is dependent on the entrepreneurial risk of partnership operations, even if the "but for" test is satisfied. We believe that the "but for" standard, as expressed in the Proposed

Regulations, improperly treats as disguised sales transactions that should properly be treated for tax purposes as contributions of property to the partnership by one partner and distributions of property by the partnership to another partner.

As recommended in the 2003 Report and consistent with the Congressional intent not to recharacterize nonabusive transactions, transfers should be treated as a disguised sale of a partnership interest only if they are "directly related" one to the other in addition to satisfying the "but for" test and, for non-simultaneous transfers, the "entrepreneurial risk" test. We understand from discussions with the IRS that the intent of the drafters of the Proposed Regulations may have been that the "but for" test would in fact be applied in a fairly narrow manner that would approximate the "directly related" test as described in more detail below. However, we believe that the "but for" test is simply too susceptible of being read to encompass attenuated chains of causation -- in the words of the children's poem, "For want of a nail, the kingdom was lost" -- when we should be looking for something that approximates a notion of "proximate cause." For example, in its most literal sense the "but for" test is met any time a partnership would not have had sufficient liquidity to make a distribution "but for" another partner's contribution. We do not believe that this was what was meant by the IRS.

We do not attribute any substantive significance to the particular words used, but we do believe that it is important that the Regulations clarify that the relevant standard is not the "but for" test applied in a broad manner. This could be achieved in a number of ways, including (i) the addition of a "directly related" test, (ii) an explicit statement in the Regulations to the

effect that the "but for" test is to be narrowly construed,⁵ and/or (iii) the addition of examples providing guidance on when the "but for" test will and will not apply.⁶

The unduly broad scope that might be given to a "but for" test is illustrated by the following example:

Example. A and B are the sole partners in partnership AB. C contributes cash to the partnership. One year later, an unexpected event occurs which makes B decide that it wants to reduce substantially its interest in the partnership, and the other partners agree to allow B to receive a non-*pro rata* distribution that will have that effect. "But for" C's contribution, the partnership would not have had sufficient funds to make the distribution to B. Accordingly, the transactions could be viewed as satisfying the "but for" test. However, regardless of whether the distribution to B is considered, based on all the facts and circumstances, to be dependent on the entrepreneurial risks of partnership operations, the transactions would not satisfy a "directly related" test and should not be viewed as a disguised sale, because they are not integrally related and there were no discussions, negotiations or understandings between C and B.

There are several reasons for supplementing the "but for" test of the Proposed Regulations with a "directly related" test.⁷ First, it is generally inappropriate to create a disguised sale in the absence of direct contact between "buyer" and seller." Second, a "but for" test can apply to a broad variety of "garden variety" transactions, in contradiction to the

⁵ Cf. Treasury Regulation section 1.6011-4(c)(4) ("substantially similar" test in definition of "listed transaction" to be broadly construed).

⁶ In this regard, we note that the examples in section 1.707-7(l) of the Proposed Regulations, involving non-simultaneous transfers, are limited to cases in which there are no facts to rebut the presumption that transactions occurring within two years constitute a disguised sale, with the obvious, but unenlightening, conclusion that a disguised sale has occurred. This is in contrast to the examples relating to disguised sales of property in section 1.707-3, which provide material guidance regarding whether or not a transaction constitutes a disguised sale.

⁷ See generally pp. 8-14 of the 2003 Report.

Congressional intent that the disguised sale rules should apply only to abusive transactions and to transactions that are truly designed to effect a transfer of a partnership interest directly from an existing partner to another person. It should not be sufficient to treat such transfers as a sale that one transfer would not have been made but for the other.

Some of the reasons for adopting a "directly related" test to determine whether there has been a disguised sale of a partnership interest are set out in pages 8-14 of the 2003 Report. First, the "directly related" test generally would not be met in the absence of any direct contact between the "buyer" and the "seller." We do not think that a selling partner and a purchasing partner with no contact and no knowledge of the other's existence should be presumed to be transacting a sale. Second, the "but for" test can result in a disguised sale of partnership interests where there are only "garden variety" cash distributions by, and cash contributions to, a partnership. Such distributions may reflect the original economic deal between the partnership and the partners and may not be intended to effect a transfer between partners. In contrast, the "directly related" test would result in a disguised sale only when there is some kind of connection, from the partners' perspective,⁸ between the selling partner and the purchasing partner, above and beyond the fact that both happen to be making transfers to or from the same partnership.

The Preamble to the Proposed Regulations at first appears to agree with our analysis when it states that the "IRS and the Treasury Department agree that ... it is appropriate that the proposed regulations [relating to disguised sales of partnership interests] be narrower

⁸ As stated by the Tax Court in *Foxman v. Commissioner*, 41 T.C. 535, 550 (1964), "[T]here may be very little, if any, difference in ultimate economic effect between a 'sale' of a partnership interest to the remaining partners and a 'liquidation' of that interest." Thus, in at least some cases, there is no reason grounded in "economic reality" to prefer one characterization of the transaction over another. (Although *Foxman* involved a "complete liquidation" of an interest which would be subject to the favorable presumption of section 1.707-7(e), the same point could be made about distributions that reduce, but do not eliminate, one partner's interest in the partnership.)

than the existing regulations [relating to disguised sales of property between a partner and the partnership]." The Proposed Regulations purport to implement the recognition of this important difference by means of the adoption of "additional safe harbors." However, a review of the Proposed Regulations reveals that only one of these safe harbors -- for contributions to and distributions from "service partnerships" -- differs from the safe harbors already applicable in the case of disguised sales of property.⁹

We believe that the substantive rules of the Proposed Regulations should be brought into accord with the conceptual framework set out in the Preamble -- the recharacterization of transfers as a disguised sale of partnership interests should occur in a significantly smaller percentage of relevant cases than the percentage of cases in which recharacterization of transfers as a disguised sale of property occurs. We believe this goal can best be realized by restricting application of the disguised sale rules, in the case of transfers which may constitute a disguised sale of a partnership interest, to situations in which the transfers are "directly related."

In the Preamble to the Proposed Regulations, the IRS expressed uncertainty as to how a "directly related" test would be interpreted or applied. We believe that the existence of a direct connection could be demonstrated by the existence of appropriate facts and circumstances, including many of the factors enumerated in section 1.707-7(b)(2) of the Proposed Regulations. We also believe that the existence of provisions in a partnership agreement mandating that, upon receipt of a contribution from a new partner, a corresponding amount is required to be distributed

⁹ The exception for transfers involving a liquidation of a partner's interest in the partnership is only a presumption (and is not even exempted from the disclosure requirements of the Proposed Regulations). The exception for Code section 708(b)(1)(B) transactions merely recognizes, in line with many other provisions of the subchapter K regulations, that there is no substantive change to the economic position of the ongoing partners as a result of such a termination. Finally, the "exception" for transfers incident to the formation of a partnership is really just a means of implementing the Proposed Regulations' coordination of the rules governing disguised sales of partnership interests with the existing Regulations on disguised sales of property by a partner to the partnership.

to existing partners, would normally be sufficient to find a direct relationship. The enumerated factors that seem to us to clearly be relevant to a determination under the “directly related” test, at least in most cases, include factors (i) (the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer), (ii) (the person receiving the subsequent transfer has a legally enforceable right to the transfer, or the right to receive the transfer is secured), (iii) (the same property (other than money) that is transferred to the partnership is transferred from the partnership), (iv) (partnership distributions, allocations or control of operations are designed to effect an exchange of the benefits and burdens of ownership of transferred property, including a partnership interest), (ix) (there were negotiations between the purchasing partner and the selling partner (or the partnership and each of the purchasing and selling partners with each being aware of the negotiations) concerning any transfer of consideration) and (x) (the selling partner and purchasing partner enter into an agreement relating to the transfers).

On the other hand, several of the factors enumerated in the proposed Regulations would not appear to have any independent probative value under a “directly related” test. These include factors (v) (the partnership holds transferred property for a limited period of time or during the period of time the partnership holds transferred property, the risk of gain or loss associated with the property is not significant), (vi) (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), (vii) (the selling partner has no obligation to return or repay the consideration to the partnership, or such obligation is due at such a distant point in the future that the present value of the obligation is small in relation to the amount of consideration transferred to the selling partner) and (viii) (the transfer of consideration by the

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

Moreover, we believe that the absence of any reduction in the partnership interest of the partner receiving a transfer of consideration should be added as a negative factor to the list contained in section 1.707-7(b)(2) of the Proposed Regulations, as it would be a strong, or perhaps dispositive, indication that no disguised sale of a partnership interest has occurred.

b) Transactions Not Involving Cash or Marketable Securities

We believe that the Regulations should make clear that a disguised sale will generally not be found in the case of a transfer of property, other than cash or marketable securities,¹⁰ by one partner to a partnership and a transfer by the partnership to another partner of other property not fungible with the property transferred to the partnership and, again, not consisting of cash or marketable securities.

Example. A and B are equal partners of partnership AB, which owns numerous investment properties. A would like to receive a distribution of a particular one of the partnership's properties and B would like to receive a distribution of another particular property. However, the partnership's capital base would be unduly depleted if these distributions were made. C then offers to contribute a new property to the partnership. The additional capital provided by C's contribution enables the partnership to make distributions to A and B. However, the contribution and distributions should not be considered a disguised sale of A's and B's partnership interests to C.

¹⁰ "Marketable securities" might be defined by reference to Code section 731(c) and the Regulations thereunder, so as to include traded commodities and similar assets. However, the precise point at which to draw the line between "marketable securities" and other property will necessarily leave some very similar instruments on either side of the line; for example, a case could be made for treating many privately placed debt instruments as "marketable securities" for this purpose.

Our conclusion that there is no disguised sale in this example is consistent with our view that there should be a strong connection, which we articulate as a "directly related" test, between a contribution and a distribution in order to construct a disguised sale under the Proposed Regulations. However, we also believe that transactions of this sort merit non-sale treatment even if a "directly related" test were not adopted and that the Proposed Regulations should provide a special rule governing such transactions. In the absence of factors indicating abuse, such as negotiations directly between the "purchasing partner" and the "selling partner," transactions involving non-fungible property do not contain a sufficiently high degree of "relatedness" to warrant departing from the ordinary rules of subchapter K governing contributions and distributions, regardless of the standard generally applicable in determining whether or not a disguised sale has occurred.

In this connection, we believe that Example 3 of section 1.707-7(l) requires clarification. In that Example, in simultaneous transactions, a new partner transfers "Investment Property" to a Partnership, while the Partnership simultaneously transfers "Whiteacre" to one of its existing partners. The Example concludes that the transfers are treated as a sale of a portion of the existing distributee partner's interest in the Partnership to the new partner. In the course of reaching the conclusion, the Example states, "There are no facts that rebut the presumption of sale treatment." Whether or not the result reached by Example 3 is correct, this statement seems incorrect. Under section 1.707-7(b)(2)(iii), a fact that may tend to prove the existence of a sale is that the same property that is transferred to the partnership by the purchasing partner is transferred to the selling partner. In Example 3, this factor was clearly absent, and its absence is certainly relevant to the determination of the proper characterization of the transaction.

c) The Two-Year Presumption Is Overly Broad

Section 1.707-7(c) of the Proposed Regulations states that, if, within a two-year period, a purchasing partner transfers consideration to a partnership and the partnership transfers consideration to a selling partner, then, 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. The presumption can be overcome only if the facts and circumstances clearly establish that the transfers do not constitute a sale.

We believe that many -- perhaps most -- combinations of contributions and distributions that occur within two years are not properly characterized as disguised sales of partnership interests. The Proposed Regulations should be seeking -- we believe by means of the application of the "directly related" test -- to identify with greater precision those transactions that are properly treated as disguised sales of partnership interests and should not presumptively apply disguised sale treatment to a broad class of transactions that do not meet that test. The practical burden of rebutting such a presumption points to the inequity of casting such a wide net. Similarly, the presumptions created by the Proposed Regulations should not undo that greater precision and extend disguised sale treatment (or the burden of "clearly establishing" a rebuttal of disguised sale treatment) to the numerous cases of contributions and distributions that have no connection with each other except for the fortuity of occurring within a two-year period. Disguised sale treatment will be the wrong tax result in a great number of cases. A two-year presumption that leads to such an incorrect result is creating the wrong default rule and should not be adopted.

Example. In Year 1, a partnership sells an asset and makes a pro rata cash distribution in excess of operating cash flow to all of its existing partners. Fifteen months

later, a new person becomes a partner in the partnership, contributing money or other property to the partnership. There are no other facts tending to establish a connection or relationship between the distribution and the contribution. These transfers should not presumptively be treated as a disguised sale.

Our objection to the two-year presumption in examples of this type is also based on practical realities. In an audit situation, it can be enormously difficult to convince an agent that a "presumption" has been overcome, regardless of the actual facts of any specific case. Accordingly, any presumption should be narrowly tailored to avoid covering cases that should not, as a substantive matter, be treated as sales.

We also think that a significant "matching" problem is created by the two-year presumption. In cases involving more than one contribution and/or distribution within a two-year period, transactions that are not directly related on to the other may be difficult to match, and the arbitrariness of any rule, whether "first-in-first-out" or a pro rata application of all contributions against all distributions, should, if possible, be avoided.

In light of the foregoing, we recommend that the section 1.707-7(c) presumption be restricted to a narrower class of cases. Although it is always difficult to draw precise lines in situations such as this, we believe that appropriate circumstances for applying the presumption appear to include: (a) if the transfers from the purchasing partner and to the selling partner occur within a *six-month* period (although, as a factual matter, the contribution and distribution may still be unrelated to each other, with the effect that the presumption should be overcome); or (b) if the transfers of consideration occur within a two-year period *and*, as described in section 1.707-7(b)(2)(ix), there were negotiations concerning those transfers between the purchasing

partner and the selling partner or between the partnership and each of the purchasing and selling partners, with each partner's being aware of the negotiations with the other partner.

d) Disclosure Rules

Under the present regulations, tax return disclosure is required:

- (a) if a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner within a two-year period, and the partner does not treat the transfers as a sale for tax purposes (unless certain favorable presumptions under section 1.707-4 apply);
- (b) if a partner treats a liability, incurred by the partner within the two-year period prior to the transfer of property to the partnership and assumed or taken subject to by the partnership, as a qualified liability on the grounds that it was not incurred "in anticipation" of the transfer of property to the partnership; and
- (c) in analogous circumstances involving potential disguised sales of property by a partnership to a partner.

The Proposed Regulations would expand these existing disclosure rules in two ways. First, the requirement that transactions be disclosed if they occur within two years of each other would be expanded to encompass transactions that occur within seven years of each other, although without any change to the underlying two-year presumptions in the Regulations. In the case of transactions potentially subject to new section 1.707-7, the Proposed Regulations would also impose a seven-year disclosure requirement. Second, the Proposed Regulations would require disclosure of all transfers of property, by a partner to a partnership or *vice versa*, where

liabilities, including liabilities that are "qualified" by reason of meeting the purely objective tests of section 1.707-5(a)(6)(i)(A), (C), and (D), are assumed or taken subject to.

The stated reason for the proposed seven-year disclosure rule is that "expanding the disclosure period to seven years might make it more likely that taxpayers would undertake the facts and circumstances determination for transfers occurring more than two years apart and would make the facts and circumstances determination easier for the IRS to administer." The stated reason for the proposed rule relating to liabilities is that "taxpayers are taking unwarranted positions regarding a partner's share of partnership liabilities before or after an assumption of or taking subject to a liability." Finally, the Proposed Regulations would "clarify" who is required to make each of the required disclosures.

We respectfully submit that the proposed changes to the disclosure rules would impose a significant burden, without a material offsetting benefit, and that a rule different from that of the Proposed Regulations should be adopted with respect to the identity of the party required to make disclosure of transactions subject to section 1.707-7.

Seven-Year Disclosure Rule. We are opposed to the proposed expansion of the existing two-year rule to a seven-year rule for a number of reasons:

(a) A seven-year rule is very onerous. In any situation in which a partner made a contribution to, or received a distribution from, a partnership, such a rule would require the preparers of the partner's return and of the partnership's return to review the partnership's books for many prior years in order to ascertain whether there had been any prior transactions with which the contribution or distribution might be "matched" for purposes of triggering a disclosure requirement.

(b) It is our experience that the two-year disclosure requirement already constitutes a significant impediment to the implementation of transactions which should, in fact, be treated as disguised sales, and that it also provides an adequate mechanism for advising the Service of transactions that are "honestly, but aggressively" not being treated as disguised sales. While there may have been extraordinary situations or taxpayers, such as those described in the Enron Report, for whom the two-year disclosure requirement was not a sufficient deterrent, we submit that no disclosure rule, presumption, or even rule of substantive law will ever be potent enough to prevent those few who are determined to engage in improper behavior from attempting to do so. We think it inappropriate to impose a significant burden on all taxpayers -- particularly a burden that they or that an auditing Revenue Agent may view, however incorrectly, as a concession of having engaged in an "aggressive" or "improper" transaction -- to deal with isolated and extraordinary abuses.

(c) A stated reason for extension of the disclosure period -- that taxpayers will "look harder" at their own transactions, presumably with the effect that more of them will be reported as disguised sales -- does not appear to provide adequate support for the Proposed Regulations. No amendments are proposed to the "non-sale" presumptions of sections 1.707-3(d) and proposed section 1.707-7(d).¹¹ Under these circumstances, it is unlikely that any taxpayer for whom a disguised sale result was undesirable would conclude, after evaluating whatever unfavorable facts and circumstances might exist and weighing them against the "non-sale" presumption, that a transaction had to be reported

¹¹ We believe that those presumptions should be retained in their present form, as they provide substantial certainty of result for the large universe of nonabusive transactions, while still giving the Service the power to challenge abusive transactions in appropriate cases.

as a disguised sale. Thus, although additional disclosure *might* make it easier for the IRS to identify cases in which it wished to undertake an evaluation of the facts and circumstances, it would not increase to any significant extent the number of disguised sales reported as such.¹²

(d) The rationale for the seven-year disclosure period is unclear, but seems to be to give the Service more time to discover transactions structured to fall just outside the two-year rule. We could comprehend a rule that required special disclosure if the return reporting the "back-end" transaction was filed within the period during which tax could be assessed on the "front-end" transaction. Seven years, however, is well beyond the normal statute of limitations, so that disclosure may be received at a time that the IRS can no longer assess tax with respect to the transaction being disclosed. A rule that calls for disclosure in such circumstances seems unnecessarily onerous.

We recommend that disclosure of transfers that are not reported as a disguised sale, whether of property between a partner and a partnership or of a partnership interest between two partners, continue to be limited to circumstances in which the transfers occur within a two-year period. An exception might be made, requiring disclosure even when the transfers are separated by more than two years, in situations in which there was a binding contract, executed prior to the end of the two-year period, to make the subsequent transfer and that subsequent transfer was then actually effected. If the Service still wishes to extend the disclosure period in an effort to combat abuses, that extension should affect only transfers that might constitute a

¹² In this regard, we note that the Enron Report, on which the Preamble to the Proposed Regulations bases the recommendation of extending the disclosure period, states that such an extension "could make a facts and circumstances determination *by the IRS* both more likely to occur and easier for the IRS to administer." As stated in text, we do not find these reasons to be sufficiently compelling to warrant implementing the proposed change in the disclosure rules.

disguised sale of property between a partner and a partnership -- and not those which might constitute a disguised sale of a partnership interest between two partners -- since, as discussed above, the Service should strive to avoid dragging a broad array of "garden variety" contributions and distributions into the disclosure regime.

Disclosure Related to Liabilities. We do not understand how the proposed extension of the disclosure rules to encompass transfers subject to liabilities is responsive to the concern stated in the Preamble to the Proposed Regulations, that "taxpayers are taking unwarranted positions regarding a partner's share of partnership liabilities before or after an assumption of or taking subject to a liability."

In the case of "qualified" liabilities, the transferring partner's share of the liability before or after the transfer is often irrelevant in determining the extent, if any, to which the assumption or taking subject to the liability is treated as part of a sale.¹³

Example. Partner A transfers Blackacre to Partnership in exchange for a 10% interest in Partnership. Blackacre has a basis of \$100 and a fair market value of \$1,000, and is subject to two qualified liabilities: a recourse debt of \$150 and a nonrecourse debt of \$550. Partner A is relieved from all liability for the recourse debt; after the transfer, another partner bears the economic risk of loss for the recourse liability. Partner A receives no consideration, other than relief from these liabilities and a partnership interest. Although A's share of liabilities is reduced from \$700 to \$55, no part of the transaction is considered a disguised sale.

¹³ A partner's share of a qualified liability is relevant only if the transfer of property is otherwise treated as part of a disguised sale, because of the receipt of other consideration in addition to assumption of liabilities and issuance of a partnership interest, *and* the reduction in the partner's share of the liability is greater than the amount computed under section 1.707-5(a)(5)(i)(B) (the amount of the qualified liability multiplied by the partner's "net equity percentage").

With disclosure required in such ordinary cases, which are numerous, the disclosures mandated by section 1.707-8 will not assist the Service in identifying those cases in which aggressive positions relating to the partners' respective shares of a liability are being taken and in separating those cases from ordinary contributions of encumbered property to partnerships. We are also concerned that the requirement of labeling of a disclosure as being made under the section 707 Regulations, which connotes that some abuse may be taking place, and, more particularly, the making of that disclosure on Form 8275¹⁴ will, on the one hand, stifle legitimate transactions or discourage compliance and, on the other hand, encourage Revenue Agents to view the disclosed transactions with an unjustifiably jaundiced eye. Accordingly, the proposed disclosure requirement relating to liabilities should not be imposed in its present form.

As an alternative, we suggest that the Service and the Treasury Department consider one or more of the following approaches: (a) addition of line items to Schedule K-1, requiring the provision of information regarding partnership contributions and distributions and related assumptions of liabilities; (b) changes to or clarification of the Instructions to Schedule K-1, to prevent the "netting" of items in the "Analysis of partner's capital account"; and (c) adding to the Regulations under Code section 721 a disclosure requirement similar to that found in Treasury Regulation section 1.351-3 for all transactions for which nonrecognition treatment is claimed under section 721. In this regard, we note that recent revisions to Schedule K-1 require providing information relevant to determining whether transactions between a partnership and its partners may have given rise to recognition of gain, particularly with respect to the manner in which capital accounts are being reported (tax basis, section 704(b), GAAP, etc.). We encourage

¹⁴ Form 8275 is used by taxpayers and income tax return preparers to "disclose items or positions . . . that are not otherwise adequately disclosed on a tax return to avoid certain penalties."

further use of Schedule K-1 to develop such information on a "real time" basis, rather than imposing disclosure requirements that may require a "look-back" through many taxable years.

To the extent that the Service is concerned about improper substantive positions that may be taken under sections 1.707-5 and 1.707-6(b), we encourage the Service to consider making substantive modifications to the regulations and/or to the "share" rules of section 1.707-5(a)(2) to address those positions and, possibly, to add a disclosure requirement in situations in which taxpayers rely on the "debt-financed transfers" rule of section 1.707-5(b)(1).¹⁵

Who Should Make Disclosure. The Proposed Regulations provide in section 1.707-8(c) that disclosure must be made by any person who makes a transfer that is required to be disclosed. In some cases, such a person may not be aware of other transfers which invoke the disclosure requirement, and, even if aware of such transfers, may not have all the information necessary to make a complete disclosure. In the case of transactions subject to section 1.707-7, we recommend that any required disclosure should be made by the partnership, as it will frequently be the only party possessing sufficient information to make the disclosure in those cases in which the parties are in fact taking the position that no sale has occurred -- indeed, the partnership may be the only party that is even aware of the existence of all of the relevant transactions.¹⁶ In limited circumstances, such as the situations described in section 1.707-7(b)(2)(ix) and (x) (negotiations or agreements between the purchasing partner and the selling partner), it may be appropriate to require disclosure by the partners if the partnership does not comply with its disclosure obligations.

¹⁵ See TAM 200436001 and CCA 200513022; Prop. Treas. Reg. sec. 1.752-2, 69 FR 49832 (2004). Any new disclosure requirement should be limited to transfers occurring within a two-year period.

¹⁶ If the "buyer" and the "seller" are both reporting the transaction as a sale and the partnership is aware of that fact, perhaps no disclosure of any kind should be required.

e) **Investment Partnerships**

Staged Closings. Investment partnerships often admit limited partners in stages over a one- to two-year period in staged closings. In order to avoid difficult valuation issues and adjustments to book capital accounts, the partnership agreements of many investment partnerships, especially those of private equity funds, require partners admitted at a later closing to contribute the amount they would have contributed upon a first closing, which may be increased by an amount equal to notional interest for the privilege of "deferring" their contribution and in some cases by an amount reflecting extraordinary appreciation in partnership assets. In those cases in which the proceeds of the capital contributions of the later-admitted partners are distributed to the earlier-admitted partners, most, though not all, agreements provide that, for capital account and other purposes, the transaction is treated as a sale by the earlier admitted partners to the new partners. The question in such cases is whether the contributions of the later-admitted partners and the distributions to the earlier-admitted partners should be viewed overall as a disguised sale of partnership interests by the earlier to the later admitted partners.

We suggest that the Regulations specifically address and clarify the treatment of staged closings of this nature. As we believe that Congress generally intended to treat these contributions and distributions as sales of partnership interests,¹⁷ staged closings (in which the proceeds of the later-admitted partners' contributions are distributed, rather than being retained by the partnership) should generally be treated as sales of partnership interests.¹⁸

¹⁷ This is essentially the factual pattern that was held not to result in a sale at the partner level in *Communications Satellite Corp. v. U.S.* 223 Ct. Cl. 253 (1980). The legislative history of section 707(a)(2)(B) indicates an intent to overturn this result and find a disguised sale in this situation.

¹⁸ In cases where no more than an interest factor is distributed to the earlier-contributing partners, to reflect the fact that they put the use of their funds at the partnership's disposal for a greater period of time, disguised sale treatment is not appropriate.

Other Issues. We also believe it would be appropriate and helpful for the Regulations to include examples applying the general rule and the two-year presumption to other commonplace contributions and distributions involving investment partnerships. These transactions occur on a frequent basis and application of the Regulations to these transactions will likely be generic, not fact-specific. While we expect that these transactions typically will not result in disguised sale treatment under the general rule, particularly if that rule is clarified to make a shifting in partners' interests essential to a finding that a disguised sale has occurred, one or more examples would provide a welcome degree of certainty, particularly if the two-year presumption in favor of disguised sale treatment is retained.

Private Equity Fund Example. IP is a partnership that meets all of the requirements set forth in Code section 743(e)(6). The limited partners of P have varying capital commitments totaling \$100x. Under the terms of the partnership agreement, the general partner is entitled to 20% of the profits. On January 1 and July 1 of each year for the first five years, the limited partners contribute (collectively) \$10x in order to fund investments by IP. Each investment is sold after three years for twice its cost and the proceeds are distributed. Accordingly, on January 1 and July 1 of each year (beginning in Year 4), IP makes a \$2x distribution to the general partner and an \$18x distribution to the limited partners (which is shared by the limited partners in proportion to their contributed capital used to fund the investment giving rise to the distribution). We believe that under the general rule none of the contributions and distributions should be treated as a disguised sale, even though the distributions could not have been made “but for” the contributions previously made by the limited partners. We believe the result should be the same regardless of the presence of one or more of the following factors:

one or more of the investments was sold (and the proceeds distributed) within two years of its acquisition; the distribution did not constitute an operating cash flow distribution; the general partner did not make any capital contribution; and, under the principles of section 1.707-7(a)(3)(ii), amounts contributed by one limited partner would be considered to have been transferred to another limited partner.

Hedge Fund Example. A, B, and C are limited partners of Partnership HF. Profits (realized and unrealized) of HF 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 HF to make a distribution to that partner of all or part of his capital account balance, provided that if HF does not have available cash it may delay the redeeming distribution for a short period of time, *i.e.*, up to 90 days. Substantially all of the assets of HF consist of publicly traded securities or liquid derivative contracts that could be sold to effect a redeeming distribution. The partnership agreement also provides that HF may admit additional partners at 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 particular quarter, D is admitted to HF and makes a \$10x contribution, and A requests and receives a \$10x distribution (which does not terminate A's interest in HF). We believe that under the general rule the contribution and distribution should not give rise to a disguised sale. We believe that result should be the same even if HF would have been required to delay the redeeming distribution to A if it were not for the contribution by D.

f) Non-simultaneous Transfers .

The Proposed Regulations' treatment of nonsimultaneous transfers can lead to some significant anomalies. Under section 1.707-7(a)(2)(i) of the Proposed Regulations, if it is determined that transfers constitute a disguised sale of a partnership interest, that sale is treated as occurring on the date of the earliest of the transfers constituting the disguised sale. Thus, if a partnership makes a distribution to a partner in partial reduction of the distributee partner's interest and the partnership later receives a contribution from a new partner, and if the contribution and distribution are treated as a sale of a partnership interest (whether by reason of application of the general rule or by reason of application of the two-year presumption), the new partner will be treated as having become a partner in the partnership on the date of the distribution to the distributee partner, even though, as a factual matter, the new partner may have not made any commitment whatsoever to make a contribution to the partnership.

It is certainly possible that, at the time of the distribution, the new partner will not have decided or even considered whether or not to make a contribution to the partnership, and it is even conceivable that the new partner will not have heard of the partnership at the time of the distribution! The rule in the Proposed Regulations, which could require the new partner to file amended returns for prior periods, seems incorrect, awkward, and onerous. The severity of this problem is significantly magnified in the Proposed Regulations, which do not reflect our suggestion to limit the number of situations in which disguised sales of partnership interests will be found by adopting a "directly related" test and to restrict the scope of the two-year presumption.

The Proposed Regulations could also lead, in certain circumstances, to results that unduly favor taxpayers, in that they provide an opportunity for retroactive shifting of income to a

newly admitted partner. If despite our recommendation the final Regulations retain this approach, clarification or examples should be provided to show how the rules will be applied to interim distributions and to allocations of profit and loss.¹⁹

We are also troubled by potential problems that could arise under the installment sale rules of Code section 453 in the case of certain nonsimultaneous transfers. Take the case of A, a citizen of the United States, and B, a nonresident alien, who are the sole partners in Partnership, with each holding a 50% interest therein having a value of \$100. On July 1, 2005, C contributes \$50 to Partnership, in exchange for a 20% interest in Partnership, with the respective interests of A and B being reduced to 40% each. On July 1, 2006, Partnership distributes \$50 to B. Following the distribution, the partners' interests in Partnership are: A, 50%; B, 25%; and C, 25%. Assume that the transfers are properly treated as a sale of a portion of B's interest to C.

Under section 1.707-7(a)(2)(ii)(A), the sale is treated as having occurred on July 1, 2005. Under section 1.707-7(a)(2)(ii)(D), on that date, C is considered to have transferred \$50 to Partnership, in exchange for what is, in effect, a \$50 promissory note issued by Partnership, and then, still on July 1, 2005, C is treated as having transferred the note issued by Partnership to B in exchange for a portion of B's interest in Partnership. On July 1, 2006, Partnership is deemed to have satisfied its \$50 note.

Such a transaction would not appear to qualify for reporting under section 453 as an installment sale of B's interest in Partnership to C, as the consideration received by B is not an

¹⁹ For example, depreciation that had previously been allocated under the "reverse section 704(c)" rules (no change in the total amount of depreciation deductions, with a preferential allocation of depreciation to the "contributing" partner generally over the property's remaining recovery period) would become subject to the rather different regime of Code section 743 ("purchasing" partner depreciates step-up in basis over new recovery period). It is unclear what would happen if the partnership did not happen to have a Code section 754 election in effect. An extensive listing of many of the technical problems arising from the Proposed Regulations' approach to nonsimultaneous transfers is contained in the comment letter thereon from Richard M. Lipton and Todd D. Golub, dated February 25, 2005, and published by Tax Analysts.

obligation of the purchaser, C, but rather an obligation of a third party, Partnership. We believe that this result is unnecessarily formalistic and unfair.²⁰ Similarly, on July 1, 2005, a full year before a single dollar was received by B, C could be obligated under Code section 1445 and the Regulations thereunder to withhold 10% of the consideration ultimately to be paid to B, if Partnership owns real property located within the United States. In fact, if the order of the transfers were reversed, C theoretically could be obligated to withhold on amounts paid by Partnership to B many months or years before C had transferred any consideration to anyone or had even become aware of Partnership's existence!

Other timing issues can also arise in the case of nonsimultaneous transfers. For example, one of a group of nonsimultaneous transfers that are treated as part of a sale of a partnership interest may be subject to significant conditions that do not rise to the level of "entrepreneurial risks of partnership operations." Suppose, for example, that a "purchasing partner" makes a contribution to a partnership, the proceeds of which are required to be distributed to another partner, in reduction of a predetermined percentage of the distributee's partnership interest, if regulatory or creditors' approvals are received. If there is a substantial likelihood that the requisite approvals may not be received, it would seem inappropriate to treat the "sale" as occurring at the time of the contribution. Similarly, if the distribution precedes the contribution, but approval was required for the making of the contribution, as might well be the

²⁰ The reference to Code section 453 in section 1.707-7(a)(2)(ii)(E) may suggest that this result is unintended. However, it is difficult to avoid this adverse result under the words of the Proposed Regulations, and no provision or example in the Proposed Regulations appears by its terms to solve this problem.

Issues similar to those discussed in the text can also arise under other provisions of the Internal Revenue Code. For example, the application of the original issue discount provisions of the Code would be different in the case of a "section 1274" purchase-money obligation issued directly by the purchaser to the seller from the application of those provisions in the case of a "section 1273" obligation of the Partnership issued to the purchasing partner in exchange for a deemed cash payment.

case in certain regulated industries, it would be inappropriate to treat the "sale" as occurring at the time of the distribution.

We suggest that the Proposed Regulations adopt a conceptual framework for nonsimultaneous transfers, regardless of their order, that does not lead to the anomalies described above, and that specific provisions be added to the Proposed Regulations to deal with at least those collateral tax problems that can commonly be anticipated (such as installment sale and withholding tax issues). We recommend that the sale be treated as occurring on the date on which the benefits and burdens of holding the partnership interest shift under general Federal income tax principles. (If a mechanical rule for determining the time of a disguised sale is desired, the sale should occur on the date of the *last* of the transfers constituting the disguised sale.) With respect specifically to the issue of installment sales, a special rule similar to that of Treasury Regulation section 1.338(h)(10)-1(d)(8) would appear to solve the problem.

g) Technical Comments

Transition Rules for Disguised Sales of Property. The Proposed Regulations appear to reach an unintended result in the case of "straddle" transactions with respect to which some, but not all, transfers that are part of a sale occur before the date of publication of final Regulations. The first sentence of section 1.707-9(a)(1) will make the "new" final Regulations applicable to transactions where *all* transfers occur on or after the date of promulgation of new final Regulations. The second sentence of that provision would cause the "existing" final Regulations to continue to apply to transactions where *all* transfers occur before the date of promulgation of new final Regulations. Neither of these rules seems literally to apply to straddle

transactions. We suggest that the existing regulations continue to apply to transactions where at least one transfer occurs before the date of promulgation of new final Regulations.

De Minimis Rules. We recognize the importance of the Proposed Regulations in preventing abusive transactions and in fulfilling the Congressional mandate in Code section 707(a)(2)(B). However, the compliance burden imposed by the proposed rules and the potential for controversy between taxpayers and the Service, particularly in cases of nonsimultaneous transfers, are substantial. Accordingly, we recommend that the Service consider the inclusion of *de minimis* rules pursuant to which transactions involving "deemed sale" consideration below a particular dollar threshold, or below a particular percentage of the total fair market value of the "selling" partner's interest, would not be treated as a sale of a portion of the partner's interest.²¹ Any *de minimis* rules should not apply where the intent to effect a sale of a partnership interest is clear, e.g. in the case of "staged closings" of investment partnerships, or in situations described in section 1.707-7(b)(2)(ix) and (x) (negotiations or agreements between the purchasing partner and the selling partner). However, any anti-abuse rule should not be written so broadly as to deprive the *de minimis* rules of their efficacy in providing substantial certainty for transactions falling within their scope.

Transfers in Liquidation of a Partner's Interest. Section 1.707-7(e) of the Proposed Regulations contains a presumption that a distribution of money or marketable securities to a partner in complete liquidation of that partner's partnership interest is not treated as a sale to a purchasing partner absent facts and circumstances that clearly establish the

²¹ The determination of appropriate thresholds for application of *de minimis* rules is essentially arbitrary. With respect to a fixed dollar amount, we suggest \$250,000, compare Code section 467(d)(2), and, with respect to a portion of the "selling partner's" interest, we suggest 5%. See Treasury Regulation section 1.45D-1(e)(3)(iii), in which 5% of operating income or 10% of the partner's capital interest is treated as *de minimis*. Transactions subject to recharacterization as a deemed sale that occur over a two-year period (and, possibly, transactions involving "related" partners) should be aggregated for purposes of these thresholds.

contrary. This presumption raises a number of questions. First, guidance and clarification are needed regarding how and when the facts and circumstances would "clearly establish" that the transfer is part of a sale. Second, it is odd that the treatment of the potential "buyer," including whether that new partner will or will not be treated as having become a partner "retroactively" on the date of the distribution, turns on whether the amounts paid to the distributee partner were in complete liquidation of that partner's interest (in which case a presumption would arise that no disguised sale had occurred) or whether those amounts reduced, but did not completely liquidate, the distributee partner's interest. Finally, if the presumption is retained in its present form, it would be logical for there to be an analogous presumption to the effect that contributions made by a partner in restoration of a deficit capital account, upon liquidation of the partnership or of the partner's interest therein, should also not be treated as part of a disguised sale.