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USING PARTNERSHIPS AS ACQUISITION VEHICLES

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Section 311 and Section 336 -- No General Utilities

1. C distributes assets to shareholder, in redemption of a portion of its stock or in complete liquidation.

2. C is taxed on the unrealized appreciation in the distributed assets under either section 311(b), 302(a) or 336. The shareholder has received a dividend or is deemed to have sold his stock in the liquidation under either section 301, 302 or 331.
Eliminating Corporate Level Tax Without Liquidating

1. Purpose: to move assets out of corporate solution without tax. Section 721. Corporation contributes assets to partnership in exchange for general partnership interest. Shareholder contributes cash to partnership in exchange for limited partnership interest.

2. Issues:
   a. Is there a partnership?
      i. If the shareholder owns 100% of corporate general partner, will the IRS characterize the partnership as a corporation? Rev. Proc. 89-12, 1989-7 I.R.B. 22; Rev. Rul. 77-214, 1977-1 C.B. 408; MCA, Inc. v. United States, 502 F. Supp. 838 (C.D. Cal. 1980), rev'd, 685 F.2d 1099 (9th Cir. 1982).

      ii. Does the state partnership law require the limited partners to vote by unanimous consent to replace the general partner after the dissolution of the partnership? Compare Treas. Reg. § 301.7701-2(b)(1) with Rev. Proc. 89-12, § 4.05, 1989-7 I.R.B. 22, 24.

      iii. The entity could be organized as a limited liability company pursuant to state law, which the IRS may permit to be taxed as a partnership. Rev. Rul. 88-76, 1988-2 C.B. 360 (Wyoming).
b. Is everyone a partner? C and SH should share in substantially all partnership items, to ensure that each has sufficient entrepreneurial risk in the partnership.

c. Is there a constructive distribution to SH? If the value of C's partnership interest is less than the value of the property it contributed to the partnership, C will be treated as making a distribution of a portion of its partnership interest to its shareholder.

d. If partnership distributions and allocations of income among family members do not correspond with each member's interest in partnership capital or do not take into account the value of a family member's services, such allocations and distributions may not be respected under section 704(e).

e. Has SH made a material contribution to the business, either in the form of a capital contribution, services, or other item of value? If not, the IRS may characterize the formation of partnership as a sham transaction. Payments from LP to SH may be characterized as distributions from C to SH. See Carriage Square, Inc. v. Commissioner, 69 T.C. 119 (1977).

f. The IRS may apply section 482 to reallocate aggressive allocations of income and deductions between C and SH.

g. Has there been a constructive liquidation of the corporation? C should retain a sufficient portion of its assets to avoid a constructive liquidation.

3. If C's assets have a fair market value in excess of the basis in the assets, C has section 704(c) built-in gain. If the assets are sold C would recognize the built-in gain.

4. Section 704(c) also allocates tax depreciation attributable to C's assets to the shareholder/limited partner to extent of his share of book depreciation.

5. Special allocations between C and its shareholder/limited partner should be respected under section 704(b) provided the allocations have substantial economic effect. If C has income from other sources, the partnership may want to allocate passive losses to C.
Frozen Partnership Interest

1. Purpose: to move assets out of corporate solution through a shift of future revenue/appreciation from corporate to non-corporate partners.

2. C contributes assets to partnership in exchange for general partnership "preferred" interest. Shareholder contributes cash to partnership in exchange for limited partnership "common" interest.

3. Sample allocation arrangement:
   a. Preferred interest has right to receive:
      i. 10% return on investment each year;
      ii. Liquidation preference up to amount contributed plus 5%.
   b. Common interest has right to receive:
      i. Income above 10% preferred return;
      ii. Liquidation right to assets above amount not allocated to preferred interest.

4. Issues:
   a. Same issues as in prior example in paragraph 2.
      i. Is there a partnership?
      ii. Does section 704(e) apply?
      iii. Will the formation of the partnership be characterized as a sham transaction?
      iv. Does section 482 apply?
      v. Has there been a constructive liquidation of the corporation?
b. Is C a partner? Does C share in all partnership items? If C's preferred interest is a section 707(c) guaranteed payment, C arguably is not a partner because it does not share in any entrepreneurial risk.

c. Is there a constructive distribution to SH? If the value of C's partnership interest is less than the value of the property it contributed to the partnership, C will be treated as making a distribution of a portion of its partnership interest to its shareholder.

i. Rev. Rul. 83-120, 1983-2 C.B 170 -- A contributes $1 million for preferred stock and B contributes $1 for all of the common stock. The common stock is valued at more than $1 because it has all of the upside potential.


d. In the case of a closely held corporation, where C is owned by the father and the limited partnership interest is owned by C's son, section 2036(c) will cause the value of the limited partnership to be included in C's estate.

i. It is expected that Congress will soon liberalize the treatment of estate freezes.

5. C can achieve similar results by leasing its assets to a related partnership.

a. Rent payments should be fixed over a long term: this permits future upside value of the business to be in the hands of the partnership.

b. The rental income to C will be passive, if section 469 applies.

c. The income from the partnership's business operations should be active to C. Such income may also be active to SH if he satisfies the section 469 material participation test for a limited partner.
1. **Purpose:** to move assets out of corporate solution without tax and without a cash transfer by the shareholder.

2. **C Corporation contributes assets to partnership in exchange for general partnership interest.** Corporate shareholder contributes C corporation's stock to partnership in exchange for limited partnership interest. No cash is needed.

3. The partnership's dividend income from C corporation's stock allocated to C is not income to C. PLR 8022010.

4. What are the capital accounts of each partner?

5. Has there been a constructive redemption by C of a portion of its stock in exchange for assets or a partnership interest?

6. **Notice 89-37, 1989-13 I.R.B. 7.** The contribution of C stock to the partnership triggers a deemed redemption of stock. C will have section 311(b) gain on a portion of the assets' built in gain. Discussed at pages 38-42 in connection with the May Company transaction.
Receipt of Profits Interest in Exchange for Services

1. P contributes $100 to the partnership in exchange for a limited partnership interest with a 95% interest in profits and losses and a 100% interest in capital.

2. Promoter, who arranges the deal and obtains bank financing, receives a general partnership interest with a 5% interest in profits and losses and a 0% interest in capital. The Promoter is required to perform managerial services for the partnership.

3. To the extent Promoter's profits interest is in exchange for past services, the transfer may be taxable under section 83. 

4. To the extent Promoter's profits interest is in exchange for continuing services, which if not performed results in a forfeiture of Promoter's interest, the interest should be subject to a substantial risk of forfeiture. In this event, the interest received is not currently taxable. However, partnership distributions to the Promoter presumably would be taxable as compensation income.

5. If a section 83(b) election is made, what is the value of Promoter's profits interest? In Campbell, the Court valued the recipient's partnership profits interest on the basis of the discounted present value of the promised tax benefits and anticipated cash flow described in the prospectus sent to the investors.

6. It is unclear whether the IRS will follow Campbell. It is possible that the IRS may choose not to follow Campbell and instead take the position advanced in G.C.M. 36346 (1977) that the receipt of a profits interest in exchange for the services of a partner should not be taxable.
1. C contributes assets in exchange for 20% of X common stock or preferred stock. P contributes cash or assets for 80% of X common stock.

2. If liabilities exceed basis, the transferor will recognize gain. Section 357(c).

3. P and X file a consolidated return. X’s income and tax attributes are included on P’s return.

4. Distributions from X to C are subject to 80% dividends received deduction. A portion of X’s earnings paid as dividends to C is subject to at least three levels of tax (to X, to C, and to C’s shareholders).

5. Pursuant to new section 1503(f), the amount of any dividend paid by X on section 1504(a)(4) (vanilla preferred) stock to C cannot be offset by P’s losses or credits.
1. C contributes assets in exchange for 50% of the X stock. P contributes cash or assets for 50% of X stock.

2. A consolidated return is not filed. Distributions to C and P are subject to 80% dividends received deduction. Twenty percent of X's income is potentially subject to three levels of tax. If X is liquidated, unrealized appreciation will be taxed to both X and its shareholders, C and P.

3. X's tax attributes cannot be applied or used by C or P.
Acquisitions -- Use of Partnerships

1. C and P each contribute assets/cash for general or limited partnership interests.

2. Section 357(c) does not apply. There is greater flexibility in avoiding income recognition on the transfer of liabilities under the section 752 regulations.

3. Multiple level tax is avoided when a partnership is used. The income and loss of the partnership are included by C and P.

4. The partnership's tax attributes pass through to C and P.

5. The section 704(b) regulations permit special allocations of income, loss, deduction and credits provided the allocations have substantial economic effect.

   a. The outer boundaries within which special allocations will be respected remain unclear. For example, C and P could substantially sell their business assets to each other without sale or exchange treatment by (1) contributing business assets to the partnership, and (2) allocating 90% of the income from business C to P and 90% of income from business P to C. The IRS can be expected to challenge the overly aggressive transaction, treating it as a disguised sale. Section 707(a)(2)(B).

6. Section 704(c) requires allocation of built-in gain to the transferring partner on a subsequent disposition of the property. Section 704(c) also has an impact on the allocation of tax depreciation. See pages 34-36, infra.

7. If the partnership is liquidated and the assets are distributed to C and P, generally no gain or loss will be recognized.
P wants to acquire C's assets. C does not want to incur any tax liability and C wants some or all of its cash now.

**Recourse Liability, General Partnership**

1. C borrows $50 on a recourse basis.

2. C contributes the assets to the partnership, with a fair market value of $100 and a basis of $50. C keeps the $50 loan proceeds and the partnership assumes C's recourse liability.


4. C is treated as being relieved of $50 of debt and as assuming $25 of the debt, resulting in a $25 constructive distribution to C. Sections 752(a), (b). C's basis in its partnership interest is $25: a $50 adjusted basis minus the $25 constructive distribution. Thus, C recognizes no gain.

5. This transaction and the transactions described below, may be characterized as "anticipatory" disguised sales under section 707(a)(2)(B). Until regulations are issued it is unclear when section 707(a)(2)(B) will apply.

   a. Whether the provision applies is a facts and circumstances determination.

   b. Facts considered include:

      (i) closeness in time between borrowing and contribution;

      (ii) does the borrowing partner have a "real" interest in the partnership
c. The IRS has informally indicated that section 707(a)(2)(B) is not intended to apply where partners have incurred legitimate prior acquisition-related debt. Should there be an exception for all legitimate business-related debt?

d. The regulations may contain a safe harbor when the contributing partner borrows six months or more prior to the contribution of property to the partnership. The regulations may also adopt a rebuttable presumption that a contribution and a later distribution are unrelated when the distribution is made two years or more after the contribution.

6. If section 707(a)(2)(B) applies, what is the result?
   a. Presumably, C is treated as selling a partial interest in the assets to P or to the partnership for $25.
   b. C remains liable for one-half of the debt -- $25.
   c. C is relieved of one-half of the debt -- $25, which should be treated as the amount realized.
   d. The amount realized is $25 and the proportionate adjusted basis is $12.50, resulting in a gain of $12.50.
   e. Do the assets have a step-up in basis?

Recourse Liability, Limited Partnership

1. Same facts as above, except that partner C is a limited partner.

2. C has no share of the liabilities, pursuant to the section 752 regulations.

3. C is treated as being relieved of $50 of debt and as receiving a $50 constructive distribution. C recognizes no gain and has a zero basis in its partnership interest: adjusted basis of $50 less $50 constructive distribution.

4. Section 707(a)(2)(B) may apply.
P wants to acquire C's assets. C does not want to incur any tax liability and C wants its cash now.

**Nonrecourse Liability, General Partnership**

1. C borrows $100 on a nonrecourse basis.

2. C contributes the assets to the partnership with a fair market value of $100 and a basis of zero. C keeps the $100 loan proceeds and the partnership assumes C's nonrecourse liability.

3. P contributes $100 in cash. Partnership profits and losses are allocated 99/1 in P's favor.

4. Under the section 752 regulations, nonrecourse liabilities are shared in the following order:

   a. First, to the extent of each partner's share of "partnership minimum gain." Partnership minimum gain is determined by calculating the excess of the amount of the nonrecourse debt over the book value of the property subject to the debt.

   b. Second, to the extent of each partners' built-in gain under section 704(c).

   c. Third, the remaining portion is allocated among partners in proportion to their respective interests in partnership profits.
5. C recognizes no gain upon contributing its assets subject to the nonrecourse debt to the partnership. There is no reduction in C's share of the $100 nonrecourse liability on the contribution and no resulting constructive distribution under section 752(b). C's share of the liability is $100 because of the section 704(c) built-in gain.

   a. However, C will recognize income when the partnership takes book depreciation deductions with respect to the encumbered property. Assume that in the first year, the partnership has $10 of book depreciation. The deductions are allocated 99/1 in P's favor -- $9.90 to P and $.10 to C. The deductions reduce the book value of the property, thus resulting in an increase in partnership minimum gain of $10 ($100 nonrecourse debt less $90 book value of property). Pursuant to the section 752 regulations, nonrecourse debt is shared first to the extent of each partner's share of minimum gain. P now has $9.90 of minimum gain. This relieves C of $9.90 of nonrecourse debt. Pursuant to section 752(b), C has a $9.90 constructive cash distribution. Because C has no basis in its partnership interest, C has $9.90 of gain.

6. C has a basis of $0 in its partnership interest.

7. This transaction may be characterized as an "anticipatory disguised sale" under section 707(a)(2)(B).

   a. Arguably, if the nonrecourse loan proceeds are used to improve the property (as opposed to using them for unrelated purposes), sale treatment is inappropriate.

   b. Arguably, the receipt of proceeds of nonrecourse debt should not be treated as a disguised sale payment.

   (1) The legislative history to section 707(a)(2)(B) indicates that Congress did not wish to treat as disguised sales the receipt of nonrecourse debt proceeds to the extent that the contributing partner remained liable for the debt and had not shifted the liability to other partners under the section 752 rules.

   (2) However, if section 707(a)(2)(B) applies to the extent nonrecourse debt is allocated to other partners, we end up with anomalous results.

   (3) Assume that C has property with a $100 value and a zero basis. C takes out a $100 nonrecourse loan and contributes the encumbered property to a partnership. Under the section 752 regulations, C retains $100 of the liability due to the $100 of
section 704(c) built-in gain. Thus, no part of the proceeds would constitute a disguised sale payment.

(4) Alternatively, assume that C has property with a $100 value and a $100 basis. C takes out a $100 nonrecourse loan, and contributes the encumbered property to the partnership. C has no section 704(c) built-in gain and is treated as being relieved of $100 of debt and as assuming a $1 share of the debt. If the rule is that receipt of nonrecourse debt is a disguised sale payment to the extent that the proceeds exceed the contributor's share of the liability, C would receive a disguised sale payment of $99. Thus, under such a rule, the higher the basis of the contributed property, the more likely it would be that receipt of nonrecourse debt proceeds will result in a disguised sale.
Taking Loan Proceeds: Post- Contribution

P wants to acquire C's assets. C does not want to incur any tax liability and C wants cash now.

**Recourse Liability, General Partnership**

1. C contributes assets to partnership, with a fair market value of $100 and a basis of $50.
2. P contributes $100 cash to partnership. P and C receive equal general partnership interests.
3. Partnership borrows $100 on a recourse basis.
4. Partnership distributes $100 loan proceeds to C.
5. C's share of liability is $50.
6. C recognizes no gain ($100 distribution less $50 adjusted basis and $50 share of liability).
7. This transaction may be subject to section 707(a)(2)(B).

**Nonrecourse Liability, General Partnership**

1. Same as above, except that partnership takes out a $100 nonrecourse loan and C has a $0 basis in its assets.
2. Upon the distribution of the $100 loan proceeds to C, C has no gain ($100 distribution less $100 share of liability -- the amount of section 704(c) built-in gain).
3. This transaction may be subject to section 707(a)(2)(B).
1. P is interested in acquiring C's assets. C does not want to incur any tax liability.

2. C contributes $100 in assets to LP; P contributes $100 cash to LP.

3. After five years, LP distributes the assets to P. P's basis in the assets is $100. Section 732(b).

4. C owns LP which owns $100 in cash. C's basis in its LP interest is $0, but LP can use cash to buy and operate the business.

5. No section 754 election should be in effect -- otherwise, basis step down under section 734.

6. Under new section 704(c)(1)(B), enacted in the Revenue Reconciliation Act of 1989, if a partner contributes property to the partnership and the partnership distributes the property to another partner within five years of the date of contribution, the contributing partner would be required to recognize any built-in gain or loss in the property.

7. Avoiding new section 704(c)(1)(B):

   a. LP redeems C's interest in the partnership before it distributes C's assets to P.

      (i) C contributes assets and P contributes cash.

      (ii) LP buys GM stock with cash and distributes GM stock to C.
(iii) C takes a $0 basis in GM stock but recognizes no gain.

(iv) If a section 754 election is in effect, the bases of assets in the partnership are stepped up.

The IRS can be expected to close this perceived loophole.

b. Leave the assets in the partnership and specially allocate the income and loss from C's assets to P. The IRS can be expected to treat overly aggressive allocations as constructive distributions.

8. Section 707(a)(2)(B) could also apply.
Installment Sale Technique

1. P is interested in acquiring C's assets. C does not want to incur any tax liability.

2. C contributes $100 in assets with a basis of $50 to LP; P contributes $100 cash to LP.

3. LP retains C's assets and makes section 736 payments of cash to C over a period of years.

4. The cash received by C is taxed to C after C recovers its basis. The transaction is intended to avoid ratable basis recovery under the installment sales rules. It would also avoid section 453A(a) -- payment of interest on deferred taxes.

5. There is no sale or exchange of C's assets, thus interest need not be paid and section 1274 should not apply.

6. If Section 754 is in effect, the remaining assets' bases will be adjusted upward when C recognizes gain on the distributions.

7. Section 707(a)(2)(B) may apply.

8. Alternatively, LP could invest cash in securities. LP redeems C's interest for securities. C recognizes no gain
and takes a basis of $50 in the securities received. Section 732(b). Inside assets have basis step up due to the Section 754 election. New section 704(c)(1)(B) does not apply. However, it is expected that Congress or Treasury will close this perceived loophole.

9. Alternatively, C's interest could be "frozen" with a preferred return. This could make C's interest more bankable, thereby permitting the interest to be pledged during the period before the interest is liquidated, without running afoul of section 453A(d).
1. B is a domestic corporation that desires capital losses to offset its capital gains.

2. A, a domestic or foreign corporation, contributes $90 cash to LP in exchange for a 90% limited partnership interest. B contributes $9 cash to LP in exchange for a 9% limited partnership interest. B contributes $1 to LP in exchange for a 1% general partnership interest.

3. In Year 1, LP buys a fixed income security for $100 and immediately sells it to X for an installment note. The note calls for $90 to be paid in the first year and a contingent payment due in the third year -- $10 plus an earn out.

4. Before the end of Year 1, X pays LP $90. Because the fixed income security was sold for a contingent total price and a fixed term, LP is required to recover its $100 basis ratably over the three-year term of the note. Treas. Reg. § 1.15A.453-1(c)(3)(i). Thus, in Year 1, LP recovers $33 of basis, resulting in a $57 gain. The gain is allocated in accordance with partnership interests: $51 to A, $5 to B and $1 to C. The gain increases the bases of the partners' interests accordingly. Section 705(a).

5. In Year 2, A's partnership interest is redeemed by LP for $90. A has a $51 capital loss pursuant to Section 731(a) ($90 liquidation distribution less $141 basis in partnership interest). A can carry back its capital loss on its corporate return to offset the capital gain in Year 1.
6. A now has a 90% partnership interest and B has a 10% partnership interest. X makes no payment on the note to LP in Year 2. Thus, the $33 of basis allocable to Year 2 is carried over to Year 3. Treas. Reg. § 15A.453-1(c)(3)(i).

7. In Year 3, X pays LP $13 ($10 plus a $3 earn out) in satisfaction of the note. The total basis allocated to Year 3 is $67. LP has a $54 loss, $49 of which is allocated to B and $5 of which is allocated to C. Prior to the year end, A and B cause the partnership to borrow money or they make a capital contribution in order to increase the basis in their partnership interests to allow them to recognize the full amount of the loss. See Section 704(d).

8. A number of issues are raised by this transaction.
   a. Is there economic substance to the transaction?
   b. Is it a true partnership if A, B, and C form LP solely to consummate the transaction?
   c. Is A a partner? If A is guaranteed against any loss or is promised a certain redemption price, A is arguably not a partner because it does not share in any entrepreneurial risk. Note that A is not redeemed for an amount equal to its capital account of $141 ($90 contribution plus $51 income allocation).
   d. Can the IRS invoke Section 446(b) on the ground that the deferral of basis does not clearly reflect income?
   e. Under Treas. Reg. § 15A.453-1(c)(7), the IRS appears to have authority only to accelerate basis, not to defer it.

9. Notice 90-56, 1990-38 I.R.B. 1. The IRS plans to amend Treas. Reg. § 15A.453-1(c)(7) to "clarify" that the IRS may require an alternative method of basis recovery where basis is inappropriately deferred. The Notice also states that the above transaction may be challenged on other grounds.
1. **Purpose:** P wants to buy C's business, without allocating part of the purchase price to goodwill.

2. C contributes to LP business assets with a value of $200, a basis of $200 and goodwill valued at $100. A contributes $3 to LP.

3. C has a 99% interest, A a 1% interest in LP.

4. C sells its interest in LP to P for $300. No section 754 election is made. P's basis in its partnership interest is $300.

5. Because of the sale of the 99% interest, the partnership is deemed to terminate. Section 708(b)(1)(B). Pursuant to the deemed termination, LP is deemed to distribute undivided interests in the assets to P and A, who are then deemed to re-contribute the assets to LP.

6. P has a step-up in the basis of its assets to $300, equal to its basis in its partnership interest. Section 732(b). The $300 of basis arguably is all allocated to the "hard" assets and none to the goodwill. Section 732(c).

7. Section 1060(d) generally should not apply because no section 754 election is in effect.
8. However, section 1060(d) also applies if section 732(d) applies. Section 732(d) applies in two instances:

a. If there has been a transfer of an interest in a partnership and within two years there is a distribution of partnership property to the transferee partner, then the transferee partner may elect to treat the adjusted basis of the distributed property as if a section 754 election had been in effect at the time of the initial transfer. Section 732(d).

b. Additionally, the IRS requires that the transferee partner treat the adjusted basis of the distributed property as if a section 754 election had been in effect at the time of the transfer of the partnership interest, whether or not the distribution is made within two years of the transfer, or is a current or liquidating distribution, if the following conditions are present:

i. At the time of the transfer the fair market value of the partnership property (other than money) exceeds 110 percent of its adjusted basis to the partnership;

ii. The allocation of basis among distributed properties pursuant to section 732(c) upon liquidation of the transferee partner's interest immediately after the transfer would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance; and

iii. A basis adjustment pursuant to section 743(b) would change the basis to the transferee partner of the property distributed. Section 732(d); Treas. Reg. § 1.732-1(d)(4).

In the above example, section 732(d) would apply to the extent the assets are subject to depreciation and therefore section 1060(d) would apply. If the assets are inventory, for example, sections 732(d) and 1060(d) would not apply.
1. C contributes to LP loss assets with a $500 basis and $100 value for a 49% interest. C's basis in LP interest is $500. LP's basis in assets is $500. P contributes $104 cash to LP for a 51% interest.

2. C sells its LP interest to B for $100. C recognizes a $400 loss. B's basis in partnership interest is $100.

3. Because C did not transfer a 50% or more partnership interest, there is no constructive termination of the partnership pursuant to section 708(b)(1)(B).

4. No section 754 election should be in effect — otherwise, there would be a basis step down in LP's assets pursuant to section 743.

5. If the LP sells its loss assets, section 704(c) allocates the loss to B. B's use of losses is limited under section 704(d). If LP incurred debt, B's use of the losses would increase.
Loss Corporation Assets - Alternative

1. C contributes to LP loss assets with a $500 basis and $100 value. C's basis in LP interest is $500. LP's basis is $500. P contributes $100 cash to LP.

2. LP waits more than two years and redeems C's interest for cash.

3. C recognizes a loss. Section 731(a). No section 754 election should be in effect -- otherwise, there would be a basis step down in LP assets.

4. Later, LP sells its assets and recognizes the loss. Loss passes to P and P affiliate subject to section 704(d), etc.

5. Section 707(a)(2)(B) and new section 704(c)(1)(B) should not apply.
S-1 and S-2 form a general partnership (GP). GP makes a section 754 election.

2. S-1 contributes to GP loss assets with a $500 basis and $100 value.

3. S-2 contributes to GP gain assets with a $100 value and $0 basis.

4. After five years (see new section 704(c)(1)(B)), GP distributes loss assets to S-2. S-2 has no loss or gain and S-2's basis goes to zero. Section 732(b).

5. GP would like to increase its basis in gain assets to $500 under section 734. But the section 755 regulations appear to prevent GP from allocating basis to its gain assets in excess of their $100 value and appear to require GP either (1) to allocate the remaining $400 of basis to goodwill (assuming in fact that there is goodwill), or (2) to hold the remaining $400 of basis in suspense until GP acquires property of a like character to which the basis can be allocated.

a. If goodwill is present, when GP disposes of the gain assets, GP may be able to recognize the $400 loss.

6. If GP distributes loss assets to S-2 within five years, S-1 would realize a $400 loss under new section 704(c)(1)(B); but section 267 would disallow the loss recognition since S-1 and S-2 are related parties. GP's basis in the gain assets is $100.
7. General partnership form limits risk that entity will be treated as an association, since there is no LP that controls GP.
1. C transfers its assets to LP. P contributes cash to LP.
2. C converts into an S Corp.
3. The earnings of the LP are passed through to SH -- no section 1374 built-in gain is recognized.
4. If C sells its LP interest or if LP sells its assets, section 1374 should apply.
1. P and S are members of a consolidated group.

2. S contributes assets to LP with a $100 value and zero basis, in exchange for a 49% partnership interest. C contributes $104 cash to LP in exchange for a 51% partnership interest. A section 754 election is in effect.

3. S distributes its LP interest to P — the section 311(b) gain is deferred (Treas. Reg. § 1.1502-13). Under section 743, the basis in LP's assets are stepped up to $100 (as to P).

4. LP sells the assets. Due to Section 743 basis step-up, there is no section 704(c) gain to allocate to P.

5. S argues that its deferred gain is not triggered because P has not disposed of its partnership interest.

6. Rev. Rul. 89-85, 1989-27 I.R.B. 9. The distribution of S's partnership interest to P is treated as a sale of the related portion of LP's assets. Thus, LP's sale of the
assets outside of the group causes S to restore the deferred gain, pursuant to Treas. Reg. § 1.1502-13(f)(1)(i).

7. On March 27, 1990, Treasury issued temporary consolidated return regulations that incorporates the holding of Rev. Rul. 89-85. The applicable rules are contained in Treas. Reg. § 1.1502-13T(1)(1) and are generally effective on or after January 1, 1989.

8. If S had a 51% interest in LP, and C had a 49% interest in LP, gain would be on recognized on the distribution transaction apart from Treas. Reg. § 1.1502-13T(1)(1). When S transfers its LP interest to P, the transfer of the 51 percent interest triggers section 708(b)(1)(B), which terminates the partnership. The partnership's property is deemed to be distributed to P and C in proportion to their interests, which are then deemed to reconstitute the assets to a new partnership. Treas. Reg. § 1.708-1(b)(1)(iv). The constructive exchange of the old partnership interest for the new partnership interest apparently is a disposition.
1. L has substantial net operating losses.
2. P wants to acquire L without the limitation of section 382.
3. L and P contribute assets/cash to LP. LP conducts or purchases a business.
4. Cash is distributed to P and taxable income is allocated to L.
5. Section 382(m)(3) denies such allocations (even if section 704(b) does not).
6. If the allocations are based on capital accounts, section 382(m)(3) should not apply.
Ceiling Rule Illustration -- Section 704(c)

1. C contributes assets (as shown above) which generate $20 income annually. P contributes a $100 CD bearing interest at 10%.

2. Under section 704(c), for purposes of allocating depreciation, P is deemed to buy one-half of C's assets contributed to LP.

3. Depreciation is allocated -- $5 to P and $1 to C.

4. The partnership generates $30 income and $6 of deductions.
   a. C is allocated: $15 income
      ___1 deduction
      $14 taxable income
   b. P is allocated: $15 income
      ___5 depreciation
      $10 taxable income

5. Same overall result if assets held individually.
1. Same as previous diagram, except C's basis in its assets is zero.

2. Ceiling rule limitation -- depreciation allocable among partners cannot exceed amount of depreciation actually taken. Here, no depreciation can be taken by partnership, so no depreciation can be allocated to L.

3. If the assets were not in a partnership, C would be taxed on $20 income, and L would have $10 of interest income which could be offset by L's losses.

4. Now, under the partnership, C has $15 of income (1/2 of $30) and L has $15 of income -- $5 shift in income to L.
Payments to Partners in Liquidation of Their Interests -- Deductible Guaranteed Payments

A

B

C

$90

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset 1</td>
<td>$30</td>
<td>$70</td>
</tr>
<tr>
<td>Asset 2</td>
<td>20</td>
<td>40</td>
</tr>
<tr>
<td>Cash</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
<td>60</td>
</tr>
</tbody>
</table>

$150 $270

1. Purpose: to achieve a deduction attributable to a payment for goodwill to a partner in liquidation of his interest.

2. When a partnership makes payments to a partner who is terminating its interest in the partnership, the payments are either section 736(a) payments that are treated as ordinary income to the partner or section 736(b) payments that generally are taxable as capital gain to the extent they exceed the partner's basis in its interest.

3. A, B and C are equal partners in LP. C wants to liquidate its interest in the partnership. C receives $90 cash -- $70 representing one-third of LP's tangible property plus $20 attributable to the value of goodwill. However, the $20 is not designated as a payment for goodwill in the partnership agreement. Because the $20 is determined without regard to LP's income, the $20 payment should be treated under section 736(a)(2) as a section 707(c) guaranteed payment that is ordinary income to C and deductible to LP.

4. In addition to the $20 payment under section 736(a), C receives a $70 section 736(b) payment. Because the section 736(b) payment exceeds the $50 basis in C's partnership interest, the fact that the $20 payment is taxable under section 736(a) rather than section 736(b) does not increase
section 736(a) rather than section 736(b) does not increase C's tax liability (so long as the capital gain/ordinary income rates remain the same).

5. Alternatively, if the partnership agreement provides that the $20 payment is for goodwill, it must be treated as a section 736(b) payment and is a non-deductible capital expenditure.

6. If the $20 payment is taxable under section 736(b) and a section 754 election is in effect, LP can step-up the basis in its assets pursuant to section 734(b) by C's $40 capital gain ($90 less $50 basis), including the $20 portion of the gain attributable to the payment for goodwill.

7. However, the section 1060 rules may apply with respect to the allocation of the $40 basis step-up among LP's assets. Under section 1060(d), allocations to goodwill or going concern value must be made using the residual method mandated by section 1060(a) upon the distribution of partnership property or the transfer of an interest in the partnership.

8. For purposes of section 1060(d), since the total value of partnership assets other than goodwill is only $210, goodwill must be assigned a value of $60 ($270 less $210). Thus, if the $20 payment to C attributable to goodwill is taxable under section 736(b), $20 of the $40 basis step-up upon liquidation of C's interest will have to be allocated to partnership goodwill.

9. While section 1060(d) on its face applies to basis adjustments under section 734(b), the temporary regulations explaining section 1060(d) (Treas. Reg. § 1.755-2T) make no mention of basis adjustments under section 734(b). It is difficult to believe that this omission is a mere oversight and it may indicate that the IRS does not interpret section 1060(d) as applying in the case of basis adjustments under section 734(b).

10. If section 732(d) applies, allocation of basis to goodwill is required by section 1060(d) and Treas. Reg. § 1.755-2T. See page 24-25, supra.
A. Formation Transaction:

1. P/S wants May Co. real estate. May Co. does not want to pay tax.

2. P/S, May Co. and May Co. Affiliate form LP. May Co. transfers real estate having value of $500 and a basis of $0. P/S transfers $500 in cash.

3. May Co. buys $500 of its stock in the open market (i.e., a redemption).

4. May Co. sells $500 of stock to LP for $500.
B. Anticipated Distribution Transaction:

1. LP operates for three years.

2. The partnership distributes the real estate to P/S in liquidation of its interest.

3. P/S holds real estate with a $500 basis (see section 732(b)). May Co. reduces its outstanding stock and disposes of the real estate without tax on the built-in gain.

C. Notice 89-37 -- Anticipated Distribution Transaction

1. The formation transaction is grandfathered. Formation transactions prior to March 9, 1989 are not subject to Notice 89-37.

2. The anticipated distribution transaction is treated as a redemption of stock in exchange for the real estate. May Co. recognizes section 311(b) gain.

3. It is unclear whether the partnership or other partners are affected by the deemed redemption. Does the partnership have income? If so how is it allocated?

4. New section 704(c)(1)(B) appears to apply to the transaction. Will they apply together? If so, how?
D. Notice 89-37 -- Formation transactions (after March 9, 1989)

1. The transfer of May Co. stock to the partnership triggers a deemed redemption of stock. May Co. will have section 311(b) gain on a portion of the real estate's built-in gain.

2. It is unclear whether the partnership or other partners are affected.
   a. Is P/S deemed to have received a portion of the real estate in redemption of its May Co. stock? If so, does the partnership hold that portion of the real estate with a stepped up basis?
   b. If P/S held appreciated May Co. stock, would it recognize that gain in the deemed redemption?
   c. Is the partnership deemed to have redeemed part of its stock in May Co. for the real estate? If so, is their gain to the partnership, what is the character of the gain (dividend or sale income) and how is it allocated?
   d. What happens if May Co. later redeems a portion of its stock. Can the stock be "redeemed" twice.
   e. The notice also applies if stock of an affiliate is transferred to the partnership.

3. It is unclear how Notice 89-37 will apply in light of new section 704(c)(1)(B).

4. Notice 89-37 notes that section 707(a)(2)(B) may also apply.
May Company Variations

Buy stock from May Co.

Buy from Public

LP buys stock
Another May Company Variation

1. The contribution of C's stock to the partnership by shareholder may trigger the deemed redemption rule under Notice 89-37.

2. It is unclear how Notice 89-37 applies to a transfer of stock to an on-going partnership.
Partnership LBO Formats

Section 338(h) (10)