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Creative Structures for the Disposition of Real Estate: Extracting Equity on a Tax-Free Basis

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CREATIVE STRUCTURES FOR THE DISPOSITION OF REAL ESTATE:

EXTRACTING EQUITY ON A TAX-FREE BASIS

by

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September 1, 2007

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I. TAX PLANNING FOR THE EXTRACTION OF EQUITY

A. A partnership is often chosen over other structures as the tax entity best suited for the conduct of a business. Inevitably, taxpayers and their advisors must consider the disposition or monetization of their interest in that business. Extracting a taxpayer’s equity on a tax-efficient basis requires that several areas of the tax law be considered, including the following:

1. The partnership disguised sales rules.
2. The anti-mixing bowl rules of Section 704(c)(1)(B).
3. The anti-mixing bowl rules of Section 737.
4. Rules addressing the distribution of marketable securities to a partner.
5. The partnership merger and division regulations.
6. The installment sale provisions.
7. The interest charge and pledge rules applicable to installment sales.
8. The treatment of capital gains.

B. These topics are addressed in this order below.

II. THE PARTNERSHIP DISGUISED SALE RULES

A. Background

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1. Contributions of property to and distributions of property from a partnership generally are not taxable to either the partnership or its partners. Sections 721 and 731.
   a. Prior to the enactment of section 707(a)(2) in 1984, taxpayers recognized that by combining a contribution of property with a distribution of cash to the contributing partner, the economic substance of a sale could be achieved without current taxation to the seller/contributing partner, provided the form of the transaction was respected.
   b. Conversely, if the seller/contributing partner received allocations of partnership taxable income under section 704(b), the remaining partners could achieve the effect of a deduction for the purchase price of the property.
   c. Longstanding regulations under sections 721 and 731 stated that a contribution of property followed by a distribution would be taxed as a sale if that was the economic substance of the transaction. Treas. Reg. §§ 1.731-1(c)(3), 1.721-1(a). Nevertheless, taxpayers enjoyed considerable success in litigating disguised sale cases, and a number of court decisions treated contribution/distribution transactions that arguably were similar to sales as tax-free transactions. See Jupiter v. United States, 2 Cl. Ct. 58 (1983); Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980); Otey v. Commissioner, 70 T.C. 312 (1978), aff’d per curiam, 634 F.2d 1046 (6th Cir. 1980).

2. Section 707(a)(2) was enacted as part of the Tax Reform Act of 1984. P.L. 98-369
   a. Section 707(a)(2)(A) provides that, under regulations prescribed by the Secretary, if a partner performs services for or transfers property to a partnership, and there is a related allocation of income and distribution of cash or property to such partner, then the transaction will be treated as a transaction between the partnership and a person who is not a partner if, under all the facts and circumstances, the transaction is more properly characterized as a payment to a partner acting in a nonpartner capacity.
   b. Section 707(a)(2)(B) provides that under regulations prescribed by the secretary, if there is a transfer of money or other property by a partner to a partnership, and there is a related transfer of money or other property by the partnership to such partner (or another partner), the
transfers will be treated as occurring between the partnership and a person who is not a partner if, when viewed together, the transfers are properly characterized as a sale or exchange of property.

c. Regulations were proposed on April 24, 1991 and finalized, with modifications, on September 25, 1992.

(i) The regulations do not contain any examples involving section 707(a)(2)(A) transactions.

(ii) The regulations have reserved a section to deal with disguised payments for services, Treas. Reg. § 1.707-2, and disguised sales of partnership interests, Treas. Reg. § 1.707-7.

B. Identifying Disguised Sales

1. Facts and Circumstances Test

a. Under the regulations, a partner’s transfer of property to a partnership and the partnership’s transfer of money or other consideration to the partner constitute a sale of the property, in whole or in part, by the partner to the partnership only if, based on all the facts and circumstances, “(i) the transfer of money or other consideration would not have been made but for the transfer of property, and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.” Treas. Reg. § 1.707-3(b)(1).

(i) Whether the distribution to the partner occurs before or after the contribution to the partnership is immaterial. Treas. Reg. § 1.707-3(c)(1).

b. The facts and circumstances existing on the date of the earliest transfer (i.e., contribution or distribution) are “generally” the relevant ones to be considered. Treas. Reg. § 1.707-3(b)(2).

c. The regulations contain a nonexclusive list of 10 factors that tend to prove the existence of a sale. Id. The factors are as follows:

(i) that the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;
(ii) that the transferor has a legally enforceable right to the subsequent transfer;

(iii) that the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(iv) that any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(v) that any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

(vi) that the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(vii) that the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(viii) that the partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(ix) that the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(x) that the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become
due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner. Treas. Reg. § 1.707-3(b)(2)(i)-(x).

2. **Two-Year Presumption**

a. The regulations provide that if within a two-year period there is a contribution by and a distribution to a partner, the transfers are presumed to be a sale of the property to the partnership. Treas. Reg. § 1.707-3(c)(1).

   (i) This presumption is rebuttable only if "the facts and circumstances clearly establish that the transfers do not constitute a sale." *Id.*

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

c. The regulations do not elaborate explicitly on the quantum of evidence necessary to "clearly establish" that either a favorable or unfavorable presumption should be rebutted.

   (i) The preamble to the final regulations states:

   "The presumptions are intended to establish which party has the burden of going forward in litigation. In addition, the regulations require that the party against whom the presumption runs must clearly establish that the transaction is or is not a disguised sale as the case may be. Thus, a mere preponderance of evidence (the standard of persuasion that would apply in the absence of the clearly establish requirement) will not suffice."

   (ii) Thus, more than a preponderance of the evidence is needed, and the party attempting to rebut the presumption has the burden of going forward in litigation (i.e., the burden of production and persuasion). Prior to the enactment of the Internal Revenue Service Restructuring and Reform Act of 1998, this represented one of the very rare
circumstances in which the Service had the burden of proof in a civil tax case.

(iii) The regulations contain two examples in which a favorable presumption is rebutted. Treas. Reg. § 1.707-3(f), Ex. 6 and Ex. 8. On the other hand, although one example discusses the factors that may tend to rebut an unfavorable presumption, Treas. Reg. § 1.707-3(f), Ex. 3, there is no example in which an unfavorable presumption is rebutted.

(iv) Examples 5 and 6 illustrate the operation of the favorable presumption. Example 6 appears to give little deference to a favorable presumption; it concludes that a favorable presumption is rebutted in a fact pattern that does not seem egregious or abusive.

(v) Treas. Reg. § 1.707-3(f) Example 5

(a) Facts: One partner transfers undeveloped land with a value of $1 million to a newly formed partnership, and the other partner contributes cash of $1 million. The partnership agreement provides for construction of a building on the land, estimated to cost $5 million, financed by a construction loan and the $1 million in cash. Upon completion of the building, which is expected to occur two years after the initial contribution of the land, a permanent loan will be put in place. To obtain the construction loan, the contributor of the cash guarantees completion of the building for a cost of $5 million. The partnership is not obligated to reimburse or indemnify this partner if he must make payment on the completion guarantee. The permanent loan will be funded upon completion of the building, which is expected to occur two years after the transfer of the land. The amount of the permanent loan is to equal the lesser of $5 million or 80 percent of the appraised value of the improved property at the time the permanent loan is closed. The partnership agreement provides that the proceeds of the permanent loan will first be
used to retire the construction loan and any excess proceeds will be distributed to the contributing partner 25 months after the initial contribution of the land. The appraised value of the improved property at the time the permanent loan is closed is expected to exceed $5 million only if the partnership is able to lease a substantial portion of the improvements by that time, and there is a significant risk that the partnership will not be able to achieve a satisfactory occupancy level. The partnership completes construction of the building for the projected cost approximately two years after the transfer of the land and is able to obtain the permanent loan in the amount of $5 million. Accordingly, the contributing partner receives a distribution of $1 million twenty-five months after contributing the land to the partnership.

(b) Analysis: The example concludes that because the transfers occur more than two years apart, the transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale. Applying the factors set forth in Treas. Reg. § 1.707-3(b)(1), the example determines that the distribution of $1 million would not have been made but for the contribution of the land to the partnership. In addition, at the time that the land was contributed, the contributing partner had a legally enforceable right to receive a transfer from the partnership 25 months thereafter of the amount that equals the excess of the permanent loan proceeds over $4 million. However, the example concludes that there was a significant risk that the appraised value of the property would be insufficient to support a permanent loan in excess of $4 million because of the risk that the partnership would not be able to achieve a sufficient occupancy level; therefore, at the time of the contribution of the land, the subsequent distribution depended on the
entrepreneurial risks of partnership operations and was not part of a sale. Example 5 illustrates the rule that, even where the subsequent distribution to a partner would not have been made but for the partner's prior contribution to the partnership, where the subsequent distribution is made more than two years after the contribution and is subject to the entrepreneurial risks of partnership operations, the transfers will not be treated as part of a sale transaction.

(vi) Treas. Reg. § 1.707-3(f) Example 6

(a) Facts: Example 6 sets forth the same facts as in Example 5, except that the partnership secures a commitment for a permanent loan without regard to the appraised value of the improved property.

(b) Conclusion: At the time of contribution of the land, the subsequent distribution is not dependent on the entrepreneurial risks of partnership operations, because the permanent lender's obligation to make a loan in the amount necessary to fund the distribution is not subject to contingencies related to the risks of partnership operations, and after the permanent loan is funded, the partnership holds liquid assets sufficient to make the distribution. Therefore, the example concludes that the transfers, although more than two years apart, are properly treated as a sale.

3. Disclosure Requirement

a. If an unfavorable presumption under the two-year rule applies, the partner does not treat the transaction as a sale for tax purposes, and the transfer is not presumed (under the rules discussed below) to be a guaranteed payment for capital, is not a reasonable preferred return and is not an operating cash flow distribution, the partner must disclose such treatment on his tax return for the year of the transfer. Treas. Reg. §§ 1.707-3(c)(2), 1.707-8.
(i) Disclosure is to be made on a completed Form 8275 or on a statement attached to the return that includes a caption identifying the statement as a disclosure under section 707, an identification of the item or items with respect to which disclosure is made, the amount of each item, and the facts affecting the potential tax treatment of the item or items under section 707. Treas. Reg. § 1.707-8(b).

(ii) The preamble to the regulations states that “[m]eeting the disclosure requirements of these final regulations does not necessarily satisfy the disclosure requirements of section 6662... and the proposed regulations thereunder (regarding the penalty for underpayment of tax)....” This statement is curious, given that a substantial understatement penalty may be avoided if disclosure is made on a completed Form 8275 or on a statement attached to the return that requires much of the same information as required in Treas. Reg. § 1.6661-4(b).

b. The partnership, as opposed to the partner(s), may make the disclosure if more than one partner transfers property to the partnership pursuant to a plan. Treas. Reg. § 1.707-8(c).

c. No penalty is expressly made applicable for failure to make the disclosure.

4. Treatment of Transferees

a. The regulations do not contain any explicit provisions regarding the application of the disguised sale rules to the transferee of a partnership interest. Treas. Reg. § 1.707-7.

b. The preamble to the final regulations provides that, where there is an absence of anti-abuse rules directed at a specific situation, such as the treatment of transferees, the Service and Treasury believe that general tax principles adequately address the issues.

c. Example: B contributes an appreciated asset to a partnership in exchange for a partnership interest. B subsequently sells his partnership interest on the installment method to X, an S corporation wholly owned by B. Thereafter, the partnership distributes $100 to X, which X uses to make other investments. Because X made no
contribution of property to the partnership, the distribution arguably should not be treated as part of a disguised sale. Although not specifically addressed in the regulations, the Service may argue that the whole transaction should be treated as a sham or that X should “step into the shoes” of B and, therefore, be subject to disguised sale treatment.

d. Rev. Rul. 2000-44

(i) In Rev. Rul. 2000-44, the IRS addressed the question of whether a corporation that acquires the assets of another corporation in a transaction to which section 381 applies succeeds to the status of the other corporation for purposes of applying the exception for reimbursements of preformation expenditures and determining whether a liability is a qualified liability.

(ii) The facts of the ruling involve Subsidiary S of Corporation P. S owned only a rental property encumbered by a nonrecourse liability, and S incurred a capital expenditures with respect to the property in December 1998. In a complete liquidation under section 332, S distributed the rental property to P subject to the liability on January 1, 1999. On January 1, 2000, P contributed the property, again subject to the liability, to partnership PRS in exchange for an interest in PRS. PRS reimbursed P for the capital expenditure incurred by S. When P transferred the property to S, the fair market value and adjusted basis of the property exceeded the liability amount.

(iii) The IRS held that, as P succeeded to the status of S under section 381, the reimbursement of capital expenditures incurred by S from PRS to P fell within the exception for reimbursement for preformation expenditures and did not give rise to a disguised sale between P and PRS. P also succeeded to the status of S with respect to the question of whether the non-recourse liability was a qualified liability. Since the liability was incurred more than 2 years prior to the date of the property's distribution to PRS, it was a qualified liability and as such the transfer by P of the property to PRS subject to the liability did not give rise to a disguised sale.
C. **Consequences of Sale Treatment**

1. **General Rules**

   a. If a contribution and distribution are treated as a disguised sale, the transaction will be treated as a sale between the contributing partner and the partnership. Treas. Reg. § 1.707-3(a)(1).

   (i) If, after application of the disguised sale rules, it is determined that no partnership exists, the transferor is treated as selling the property to the person or persons that acquired ownership of the property for tax purposes. Treas. Reg. § 1.707-3(a)(3).

   b. **Part sale, part contribution**

      (i) If the value of the consideration distributed to a partner is less than the value of the property contributed to the partnership, the transaction will be treated as a sale in part and a contribution in part. Treas. Reg. § 1.707-3(f), Ex. 1.

      (a) The partner must prorate the basis in the property between the portion of the property sold and the portion of the property contributed.

      (ii) The regulations do not appear to restrict the partner's ability to designate property as being sold or contributed ("cherry pick"). Thus, if the partner sells high basis property and contributes low basis property to the partnership, gain can be avoided.

      (a) Example: A contributes property 1 with a $400 value and 0 basis to partnership AB formed with B. In the same transaction, A sells property 2 with a $200 value and $200 basis to AB partnership, and receives $200 in cash from AB partnership. B contributes $400 cash to AB partnership. If the form is respected, A recognizes no gain.

      (b) Originally, the proposed section 707 regulations would have "aggregated" this transaction, i.e. treated the transaction as a transfer of property with a $600 value, $200 basis. The receipt of the $200 in cash would
have been treated as a disguised sale of one-third of the property and the partner would have recognized gain.

(c) In response to criticism, the rule requiring a partner to allocate the distribution among the contributed properties based on their fair market values was deleted. See Preamble to Final Regulations.

(d) Several cases and rulings in the installment sale area conclude that where a taxpayer sells multiple assets in a deferred payment sale, the seller can allocate the cash down payment to assets that do not qualify for installment reporting (such as inventory) and the note to assets that do. See Collins v. Comm'r, 48 T.C. 45 (1967), acq. 1967-2 C.B. 2.; Monaghan v. Comm'r, 40 T.C. 680 (1963); Rev. Rul. 68-13, 1968-1 C.B. 195; Rev. Rul. 57-434, 1957-2 C.B. 300. Arguably, if the taxpayer can designate which property is sold for cash and which for a note for purposes of section 453, the taxpayer should be able to designate which property is transferred to a partnership in exchange for cash and which is transferred in exchange for a partnership interest. See also Brown v. Comm'r., 27 T.C. 27 (1956), acq. 1957-2 C.B. 4 (in an incorporation of a partnership, designation of property transferred for stock versus property transferred for an installment obligation was respected).

(e) However, there is authority in the section 351 area that suggests that “cherry picking” is not permitted. See, e.g., Rev. Rul. 68-55 (in a transfer of multiple properties for stock and cash, the transferor must allocate stock and cash to each property based on relative fair market values).

2. **Deferred Payment Sales**

   a. When a partner contributes property to a partnership and at a later date receives a distribution that is recharacterized as disguised sale proceeds, the partnership is treated as issuing to the partner on the date of sale an obligation to transfer cash or other consideration to the partner. Treas. Reg. § 1.707-3(a)(2).

   (i) The disguised sale may constitute an installment sale to which section 453 applies. Id.

   (ii) The rules of section 1274 (or section 1274A or 483) will apply to impute interest on the obligation if any payments are due more than six months after the sale. Treas. Reg. § 1.707-3(f), Ex. 2.

   (a) If a contribution of property to a partnership coupled with a distribution to the contributing partner made more than six months later is recharacterized as a disguised sale with respect to which interest is imputed, the capital accounts of the partners may end up with balances different from the balances that would have existed if the form of the transaction were respected. Distortion of the economic relationship of the partners may result. See Blake D. Rubin et al., The Proposed Partnership Disguised Sale Regulations, 52 Tax Notes 1051 (1991).

   b. The requirement that a deferred payment disguised sale be treated as occurring on the date that the partnership acquires the contributed property, coupled with the two-year presumption discussed above, raises the specter that a transaction properly treated as a contribution in the year in which it occurs may be retroactively recast as a sale based on facts occurring in a later year.

   (i) As a general matter, a taxpayer has no legal obligation to file an amended return. Bernard Wolfman et. al., Standards of Tax Practice, §207.4.1 (3d ed. 1995).

   (ii) It is difficult to imagine that the taxpayer would be subject to the substantial understatement or
negligence penalty in a case such as this, and no specific penalty applies for failure to make the disclosure required by Treas. Reg. § 1.707-8.

(iii) A substantial authority penalty should not apply if substantial authority existed for the position that the transfer was a contribution on the last day of the taxable year in which the transfer occurred. Treas. Reg. § 1.6662-4(d)(3)(iv)(C).

(iv) Provided the taxpayer acted in good faith, no negligence penalty should apply. See section 6664(c)(1).

(v) As a result, taxpayers who find themselves in this position are likely to follow the path of least resistance and ignore the problem.

D. **Special Rules**

1. **Guaranteed Payments**

   a. A guaranteed payment for capital made to a partner is not treated as part of a sale of property under the disguised sale rules. Treas. Reg. § 1.707-4(a)(1)(i).

   b. A “guaranteed payment for capital” is defined as “… any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner’s capital. Section 707(c). For this purpose, one or more payments are not made for the use of a partner’s capital if the payments are designed to liquidate all or part of the partner’s interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership.” Treas. Reg. § 1.707-4(a)(1)(i).

   c. A payment of money to a partner that is characterized by the parties as a guaranteed payment for capital, is determined without regard to the income of the partnership, and is “reasonable” will be presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the payment is not a guaranteed payment for capital and is part of a sale. Treas. Reg. § 1.707-4(a)(1)(ii).

   (i) A payment that is characterized as a guaranteed payment for capital is “reasonable” in amount if the
sum of any guaranteed payment for capital and preferred return that is payable for that year does not exceed the amount determined by multiplying the partner's unreturned capital at the beginning of the year or the partner's weighted average capital balance for the year by the safe harbor interest rate for that year. Treas. Reg. § 1.707-4(a)(3)(ii).

(ii) The safe harbor interest rate for a partnership taxable year equals 150 percent of the highest applicable federal rate in effect at any time from the time that the right to the guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year. Id.

(iii) A partner's unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than transfers of money that are presumed to be guaranteed payments for capital, reasonable preferred returns, or operating cash flow distributions. Id.

d. A payment to a partner that is characterized by the parties as a guaranteed payment for capital and that is not reasonable will be presumed not to be a guaranteed payment for capital. Treas. Reg. § 1.707-4(a)(1)(iii).

(i) This presumption can be rebutted only by facts and circumstances that clearly establish the contrary. Id.

e. If a payment to a partner is characterized by the parties as a guaranteed payment for capital but is not respected as such, the payment is subject to the general disguised sale rules, including the presumptions for transfers made less than or more than two years apart. Treas. Reg. § 1.707-4(a)(1)(iii).

f. The preamble to the regulations states that “[t]he final regulations do not provide explicitly that a distribution properly characterized as a guaranteed payment for services [will] not be treated as part of a sale” because such a
distribution is not related to a transfer of property by a partner. In situations where a partner both contributes property and performs services, planners may prefer to characterize the guaranteed payment as for services in an attempt to avoid the ambit of Treas. Reg. § 1.707-4(a)(4) Example 2 or to avoid exceeding a "reasonable" return.

2. **Preferred Returns**

   a. A distribution of money to a partner that is characterized by the parties as a preferred return and that is "reasonable" is presumed not to be part of a sale of property to the partnership, unless the facts and circumstances clearly establish otherwise. Treas. Reg. § 1.707-4(a)(2).

   b. The regulations define the term "preferred return" to mean a "preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain." Id.

   c. The regulations do not contain an example involving a preferred return.

3. **Cash Flow Distributions**

   a. A distribution of operating cash flow is presumed not to be part of a sale of property contributed to the partnership, unless the facts and circumstances clearly establish otherwise. Treas. Reg. § 1.707-4(b)(1).

   b. Transfers of money by a partnership to a partner during a taxable year will constitute operating cash flow distributions to the extent that (1) such distributions are not presumed to be guaranteed payments for capital, (2) such distributions are not reasonable preferred returns, (3) such distributions are not characterized by the parties as distributions to the recipient partner acting in a capacity other than as a partner, and (4) such distributions do not exceed the product of (a) the net cash flow of the partnership from operations for the year multiplied by (b) the lesser of the partner's percentage interest in overall partnership profits for that year or over the life of the partnership. Treas. Reg. § 1.707-4(b)(2)(i).

   c. For any taxable year, in determining a partner's operating cash flow distributions for the year, the regulations permit the use of the partner's smallest percentage interest under
the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year. Treas. Reg. § 1.707-4(b)(2)(ii).

d. The regulations define a partnership’s net cash flow from operations for a taxable year as an amount equal to “the taxable income or loss of the partnership arising in the ordinary course of the partnership’s business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by -- (A) Principal payments made on any partnership indebtedness; (B) Property replacement or contingency reserves actually established by the partnership; (C) Capital expenditures when made from other than reserves or from borrowings the proceeds of which are not included in operating cash flow; and (D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.” Treas. Reg. § 1.707-4(b)(2)(i).

e. The regulations provide that in the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership applying the same principles described in the definition of net cash flow from operations, so that the amount of the upper-tier partnership’s operating cash flow distributions is neither overstated nor understated. Treas. Reg. § 1.704-4(b)(2)(iii).

4. Preformation Expenditures

a. The regulations provide that distributions made to reimburse partners for certain capital expenditures are not disguised sale proceeds. Treas. Reg. § 1.707-4(d).

b. To qualify for reimbursement under this rule, the capital expenditure must have been incurred within two years before the property contribution to the partnership and must be for partnership organization and syndication costs described in section 709 or for property contributed to the partnership by the partner. Id.

(i) Reimbursement for expenditures in this last category may not exceed 20 percent of the value of the contributed property at the time of the
contribution, unless the value of the contributed property does not exceed 120 percent of the partner’s adjusted basis in the contributed property at the time of contribution.

(ii) The calculation of the 20 percent limitation with respect to reimbursements for contributed property is unclear where multiple properties are contributed.

(a) Is the 20 percent limitation computed by reference to all property contributed by the partner, or is it computed by reference only to the value of the property with respect to which the qualifying capital expenditure is made? The regulations do not answer this question.

c. Relationship to Qualified Liabilities

(i) As discussed below, contributions to a partnership of property encumbered by acquisition indebtedness are generally not subject to disguised sale treatment.

(ii) Together, the rule regarding reimbursement of capital expenditures and the favorable treatment of acquisition indebtedness creates an incentive for taxpayers to debt-finance property that may later be contributed to a partnership.

(iii) Example: A purchases property for $100, contributes it to a partnership and asks for reimbursement. This reimbursement will be subject to the preformation rules. However, if A borrows $100, purchases property and contributes such property to the partnership subject to the debt, there is no limitation on reimbursement because the debt is a qualified liability (see below).

E. Treatment of Liabilities

1. Encumbered Property

a. In the case of a transfer of property in which the partnership assumes or takes subject to a liability other than a “qualified liability,” the entire amount of the liability that is shifted to other partners is treated as an amount realized from a disguised sale, regardless of whether the partner receives any cash from the partnership.
(i) The portion of the liability treated as shifted to other partners depends on whether the liability is recourse or nonrecourse.

(ii) A special set of more favorable rules applies with respect to "qualified liabilities."

2. **Sharing of Liabilities**

   a. A partner's share of a liability that is a recourse liability equals the partner's share of the liability under the rules of section 752 and the regulations thereunder. Treas. Reg. § 1.707-5(a)(2)(i).

   (i) A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under Treas. Reg. § 1.752-1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section.

   (ii) A partnership liability is a recourse liability of the partnership to the extent that one or more partners bear the economic risk of loss for such liability. Treas. Reg. § 1.752-1(a)(1).

   (iii) A partner's share of a recourse liability equals that portion of the liability for which such partner bears the economic risk of loss. Treas. Reg. § 1.752-2(a).

   b. A partner's share of a nonrecourse liability is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under Treas. Reg. § 1.752-3(a)(3). Treas. Reg. § 1.707-5(a)(2)(ii).

   (i) A partnership liability is a nonrecourse liability to the extent that the obligation is a nonrecourse liability under Treas. Reg. § 1.752-1(a)(2) or would be a nonrecourse liability of the partnership under Treas. Reg. § 1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section.

   (ii) A partnership liability is a nonrecourse liability to the extent, but only to the extent, that no partner bears the economic risk of loss for the liability. Treas. Reg. § 1.752-1(a)(2).
3. **Qualified Liabilities**

a. The regulations define four categories of liabilities that are "qualified liabilities" as follows:

(i) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property, provided the liability encumbered the property throughout that two-year period. Treas. Reg. § 1.707-5(a)(6)(i)(A).

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

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

(b) This presumption does not apply to liabilities described in Treas. Reg. § 1.707-5(a)(6)(i)(C) or (D) (i.e., acquisition or improvement liabilities and liabilities incurred in the ordinary course if substantially all assets used in the activity are transferred to the partnership).

(c) If a partner treats a liability incurred within the two-year period as a qualified liability, the treatment must be disclosed in accordance with Treas. Reg. § 1.707-8. Treas. Reg. § 1.707-5(a)(7)(ii).

(iii) A liability that is allocable under the interest tracing rules of Treas. Reg. § 1.163-8T to capital

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

b. The amount of any qualified liability that is a recourse liability may not exceed the fair market value of the contributed property which is encumbered by such liability (less any other liabilities that are senior in priority and that either encumber such property or that are described in the third and fourth categories described above) at the time of the transfer. Treas. Reg. § 1.707-5(a)(6)(ii).

c. If a contribution of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership’s assumption of or taking subject to a qualified liability in connection with the contribution of property will not be treated as part of a sale. Treas. Reg. § 1.707-5(a)(5)(i).

d. If property encumbered by a qualified liability is contributed to a partnership in a transfer that is characterized as a disguised sale (for reasons other than the assumption of the qualified liability), the amount of the liability treated as consideration is the lesser of (1) the amount of consideration that the partnership would be treated as transferring to the partner had the liability constituted a nonqualified liability, or (2) the amount obtained by multiplying the amount of the qualified liability by the partner’s “net equity percentage” with respect to the contributed property. Treas. Reg. § 1.707-5(a)(5)(i).

(i) A partner’s “net equity percentage” with respect to an item of contributed property equals the percentage determined by dividing:

(a) the aggregate transfers of money or other consideration actually or deemed to be received by the partner from the partnership (other than any transfer attributable to the qualified liability) that are treated as
proceeds realized from the sale of the transferred property, by

(b) the excess of the fair market value of the contributed property at the time it is transferred to the partnership over any qualified liability encumbering the property (or, in the case of any qualified liability that is described in categories three and four above, that is properly allocable to the property). Treas. Reg. § 1.707-5(a)(5)(ii).

4. **Debt-Financed Distributions**

a. The regulations provide that if a partner contributes property to a partnership and the partnership incurs a liability all or a portion of the proceeds of which are allocable under Treas. Reg. § 1.163-8T to a distribution of money or other consideration to the partner made within 90 days of incurring the liability, the distribution of money or other consideration to the partner is taken into account as disguised sale proceeds only to the extent that the amount of money or the fair market value of the other consideration distributed exceeds that partner’s “allocable share” of the partnership liability. Treas. Reg. § 1.707-5(b)(1).

b. A partner’s allocable share of the partnership liability equals the amount obtained by multiplying the partner’s share of the liability (determined in the same manner as the sharing of nonqualified liabilities) by the fraction obtained by dividing the portion of the liability that is allocable under Treas. Reg. § 1.163-8T to the money or other property transferred to the partner by the total amount of the liability. Treas. Reg. § 1.707-5(b)(2).

c. Special rules are provided for debt-financed transfers to more than one partner pursuant to a plan, subsequent reductions in a partner’s share of liabilities, and refinancings. Treas. Reg. §§ 1.707-5(a)(4), 1.707-5(a)(3), 1.707-5(c).

F. **Disguised Sales by Partnerships to Partners**

1. The regulations provide that rules similar to those provided in Treas. Reg. § 1.707-3 will apply in determining whether a distribution of property by a partnership coupled with a transfer of money (or other consideration) by that partner to the partnership
will be treated as a sale of the distributed property. Treas. Reg. § 1.707-6(a).

2. The regulations provide that rules similar to those provided in Treas. Reg. § 1.707-5 will apply to determine the extent to which an assumption of or taking subject to a liability by a partner in connection with a transfer of property by the partnership will be considered part of a sale. Treas. Reg. § 1.707-6(b).

3. The regulations provide that disclosure requirements similar to those in Treas. Reg. §§ 1.707-3(c)(2) and 1.707-5(a)(7)(ii) are also mandated in Treas. Reg. § 1.707-6(c).

G. **Disguised Sales of Partnership Interests**


2. Because the regulations did not address the issue, some practitioners believe that such transactions can be accomplished without risk of challenge.

3. However, although there are no regulations addressing the issue, cases in which taxpayers prevailed on the issue (e.g., Jupiter Corp. v. U.S., 2 Cl. Ct. 58 (1983); Communications Satellite Corp. v. U.S., 625 F.2d 997 (Ct. Cl. 1980)) were cited in the legislative history as examples of transactions which section 707(a)(2)(B) was designed to combat. S. Rep. No. 169, 98th Cong. 2d Sess. at 230 (1984).

4. It appears likely that any future regulations likely will not have a retroactive effective date. Nevertheless, a taxpayer contemplating a disguised sale of a partnership interest should analyze the transaction based on the language of the statute and the legislative history in order to determine whether current law would tax the transaction and should take into account two recent actions by the IRS: FSA 200024001 and TAM 200037005.

5. In FSA 200024001, the Service addressed the issue of whether a transaction between a partner and a partnership constituted a liquidation of the partner’s interest in the partnership or whether the transaction constituted a sale among the partners.

   a. In the field service advice, Q (a wholly owned subsidiary corporation of domestic corporation T), R (a wholly owned subsidiary domestic corporation of foreign corporation S) and U (a foreign corporation partly owned by S), formed P, a domestic partnership. Q and R contributed assets and U
contributed cash. In August of the fourth year following the formation of the partnership, the parties executed a Redemption Agreement providing that on September 30 of the fifth year, Q's entire partnership interest would be redeemed for a fixed amount of cash plus contingent payments based on future sales for the next several years, subject to a cap. The agreement contained a provision through which, if a specified notice were provided, the transaction could be structured as a sale. The agreement also specified that the parties agreed to treat the redemption distributions as distributions by the partnership under Code Sec. 731 for income tax purposes when such payments were made to Q. Ten days prior to September 30 of the fifth year, R and U entered into a Contribution Agreement whereby U would make a capital contribution to the partnership in order to fund the initial redemption payment to Q and no later than the due date of each contingent payment required under the Redemption Agreement, U would be required to make an additional capital contribution to the partnership in an amount equal to the amount of the contingent payment. As a result of the contributions and distributions, U's partnership interest increased, whereas R's interest remained constant.

b. In the FSA, the Service acknowledged that Subchapter K was adopted in part to increase flexibility among partners in allocating partnership tax burdens, citing Foxman v. Commissioner, 41 T.C. 535, 550-51 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965). However, the Service stated that “[t]his flexibility . . . is limited by the overarching principle that the substance of the transaction is controlling for tax purposes and that the economic substance of the transaction, and not the form, determines its characterization.” FSA 200024001 (citing Twenty Mile Joint Venture, PND, Ltd. v. Commissioner, 2000-1 U.S.T.C. ¶50,124 (10th Cir. 1999), affg in part and appeal dismissed in part, T.C. Memo. 1996-283; Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793, 813-14 (1988)). The Service noted that “[t]o permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.”

c. The Service agreed that the form of the transaction was a liquidation of Q's entire partnership interest, as provided for in the recitals to the Redemption Agreement.
Nevertheless, the Service found the following "elements of artificiality" present in the transaction:

(i) the funds used to terminate Q's interest were derived not from the partnership but from U,

(ii) Q's entire interest in the partnership would be redeemed for a fixed amount of cash and certain contingent payments;

(iii) ten days prior to the date of redemption, R and U entered into the Contribution Agreement pursuant to which U agreed to contribute additional funds to the partnership in order to fund the payment to Q and to fund future contingent payments to be made to Q; and

(iv) the continuing partners' interest did not increase proportionately upon the withdrawal of the partner.

d. The Service concluded that the overarching business purpose for the transaction was to sell Q's partnership interest in the partnership to U and the transfers by U to P followed by the transfer from P to Q, when viewed together, were properly characterized as a sale or exchange of Q's partnership interest under Code Sec. 707(a)(2)(B).

6. In TAM 200037005, the Service addressed the issue of whether a series of transactions resulting in the reconfiguration of a partnership into an umbrella partnership real estate investment trust constituted a disguised sale of a portion of the original partners' interests in the partnership.

a. The original partnership ("P1") was formed by the Original Partners and was in the business of leasing and managing shopping centers. In a series of transactions, P1 received loans from two trusts (the "TR Loans"), which also acquired options (the "TR Options") to purchase limited partnership interests in P1. P1 used some of the funds from the TR Loans and the TR Options to make loans to certain of the Original Partners (the "Partner Loans"), who in turn used some of the loan proceeds to make their capital contributions to P1.

b. The parties thereafter decided to reconfigure P1 as an umbrella partnership in connection with a public offering of a real estate investment trust. Although the redacting of the TAM makes it hard to follow, it appears that the Original
Partners contributed their interests in P1 to P2, a newly formed second partnership, which had the same partners and ownership as P1, except for nominal contributions by another trust (wholly owned by a personal friend of one of the Original Partners) and a corporation (wholly owned by one of the Original Partners). P1 made a distribution to P2 of the Partner Loans. The REIT made its public offering and, among other things, acquired the TR Loans and TR Options. The REIT then contributed the TR Loans and TR Options and various other property into P1 and was admitted as a partner.

c. The Service concluded that the existence of P2 should be disregarded and that, in substance, the reconfiguration was the sale of a portion of the Original Partners' interests in P1 to the REIT. The Service stated:

> When P1 distributed the [Partner Loans] to P2, the Original Partners no longer had an obligation to repay P1 the borrowed funds. Although in form the Original Partners still had an obligation to P2 to repay the borrowed funds, the borrowers essentially owed the funds to themselves because they were directly or indirectly both the borrower and the lender of the funds. When P1 distributed the [Partner Loans] in partial liquidation of P2's (and hence, the Original Partners') interests in P1, and [the REIT as holder] of the TR Loan converted [its] debt interest into an equity interest in P1 by contributing the TR Loan to P1, a permanent shift in the equity ownership of P1 occurred. The Reconfiguration was in substance a sale by the Original Partners of a portion of their equity interest in P1 to . . . REIT undertaken through related contributions to and distributions from P1.

d. The Service thus concluded that, in substance, the Partner Loans had been distributed to the Original Partners. The Service apparently further concluded that such distribution should be treated as if P1 had made a cash distribution to the Original Partners in an amount equal to the Partner Loans, and the Original Partners immediately thereafter repaid the Partner Loans to P1. This recharacterization of the transaction seems strained, to say the least. The loans in fact remained outstanding. Moreover, they were owed to a controlled partnership (P1) before the transaction and owed to a different controlled partnership (P2) after the
transaction. The transaction thus did not change the relationship between the putative debtor and creditor in any material way, and it is therefore difficult to rationalize the Service’s conclusion that the reconfiguration should be viewed as causing the loans to go out of existence for tax purposes.

e. Nevertheless, given the Service’s determination that the transaction should be treated as involving a cash distribution from P1 to the Original Partners, it is not surprising that the Service concluded that the reconfiguration was similar to the substance of the transactions in *Jupiter Corp.*, *supra*, and *Communications Satellite, supra*, both of which were cited by Congress in enacting Code Sec. 707(a)(2)(B).

f. The Service specifically addressed the impact of the lack of regulations governing disguised sales of partnership interests, concluding that Pittway permitted it to enforce section 707(a)(2)(B) even in the absence of regulations.

g. The Service also held that, alternatively, even if the reconfiguration were not treated as a disguised sale under Code Sec. 707(a)(2)(B), the Partner Loans should be treated as distributed to the Original Partners, resulting in a deemed distribution of cash to them in excess of the Original Partner’s bases in their partnership interests. Presumably, the Service’s analysis here was premised not on Code Sec. 752(b), but rather on the theory that a distribution by a partnership to a partner of a note receivable from the partner should be treated in the same manner as a distribution of cash to the partner followed by repayment of the note.

III. ANTI-MIXING BOWL RULES: SECTION 704(c)(1)(B)

A. Gain Recognition

1. Section 704(c)(1)(B) provides that if a partnership either directly or indirectly distributes “section 704(c) property” to any partner other than the contributing partner within seven years of the property’s contribution, then the contributing partner must recognize gain or loss as if the property had been sold for its fair market value at the time of the distribution.

   a. The character of the gain or loss is determined as if the property had been sold to the distributee.
b. Adjustments to the partner's adjusted basis in its partnership interest and to the adjusted basis of the distributed property shall be made to reflect any gain or loss recognized.

c. Section 1063 of The Taxpayer Relief Act of 1997, P.L. 105-34, increased the number of years in which precontribution gain may be recognized from five to seven years. The regulations do not reflect this change. However, this outline will discuss the regulations as if the change had been made.

2. Property is section 704(c) property if at the time of its contribution to the partnership, its book value differs from the contributing partner's adjusted tax basis in the property. Treas. Reg. § 1.704-3(a)(3)(i).

a. For this purpose, book value equals, at any given time, fair market value at the time of contribution less subsequent cost recovery deductions and other events that affect the property's basis. Id.

3. Section 704(c)(1)(B) and the regulations thereunder apply to the extent that a distribution by the partnership is a distribution to the distributee partner acting in its capacity as a partner. Treas. Reg. § 1.704-4(a)(2). Thus, if a contribution and distribution are properly treated as a "disguised sale" under section 707, then section 704(c)(1)(B) does not apply.

4. **Fair Market Value**

a. Fair market value is the price a willing buyer would pay a willing seller for the property at the time of distribution, neither being under a compulsion to buy or sell and both having reasonable knowledge of the relevant facts. Treas. Reg. § 1.704-4(a)(3).

b. The fair market value assigned by a partnership will be accepted, provided that the value is reasonably agreed upon by the partners in an arm's length negotiation and the partners have sufficient adverse interests. Id.

5. **Determination of seven-year period**

a. The seven-year period begins on the date the property is contributed to the partnership. Treas. Reg. § 1.704-4(a)(4)(i).
b. A termination of the partnership under section 708(b)(1)(B) does not begin a new seven-year period for each of the partners with respect to their section 704(c) property.

6. **Character of gain or loss**

a. The character of the gain or loss recognized by the contributing partner is the same as the gain or loss that would have resulted if the distributed property had been sold by the partnership to the distributee partner at the time of the distribution. Treas. Reg. § 1.704-4(b)(1).

7. **Exceptions**

a. Section 704(c)(1)(B) does not apply to property contributed to the partnership on or before October 3, 1989. Treas. Reg. § 1.704-4(c)(1).

b. If, in a liquidating distribution, an interest in the section 704(c) property is distributed to the noncontributing partner and the contributing partner also receives an interest in the section 704(c) property, then section 704(c)(1)(B) is inapplicable if the built-in gain or loss in the contributing partner’s interest (determined immediately after the distribution) is equal to or greater than the gain or loss on that property which would have been allocated to the contributing partner under section 704(c)(1)(A) on a sale of the contributed property to an unrelated party immediately before the distribution. Treas. Reg. § 1.704-4(c)(2).

c. Section 704(c)(1)(B) does not apply to the deemed distribution of an interest in the partnership caused by the termination of the partnership under section 708(b)(1)(B). Treas. Reg. § 1.704-4(c)(3).

   (i) A subsequent distribution of section 704(c) property by the new partnership to a partner of the new partnership is subject to 704(c)(1)(B) to the same extent that a distribution by the terminated partnership would have been subject to section 704(c)(1)(B). Id.

d. Section 704(c)(1)(B) does not apply to a transfer by a partnership (transferor partnership) of all its assets and liabilities to a new partnership (transferee partnership) in an exchange described in section 721, followed by the distribution of the interest in the transferee partnership and
liquidation of the transferor partnership as part of the same plan or arrangement. Treas. Reg. § 1.704-4(c)(4).

(i) A subsequent distribution of the section 704(c) property by the transferee partnership to its partner is subject to 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to section 704(c)(1)(B). Id.

e. Section 704(c)(1)(B) does not apply to incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. Treas. Reg. § 1.704-4(c)(5).

f. Section 704(c)(1)(B) does not apply to the distribution of an undivided interest in property to the extent that the undivided interest does not exceed the undivided interest in the same property, if any, contributed by the distributee partner. Treas. Reg. § 1.704-4(c)(6).

(i) The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee. Id.

8. Basis Adjustments

a. The contributing partner’s basis in his partnership interest is increased by the amount gain, or decreased by the amount of the loss, recognized by the partner under section 704(c)(1)(B). Treas. Reg. § 1.704-4(e)(1).

b. This increase or decrease is taken into account in determining (i) the contributing partner’s adjusted tax basis under section 732 for any property distributed to the partner as part of the same distribution as the distribution of the contributed property, other than like-kind property, and (ii) the amount of the gain recognized by the contributing partner under section 731 or section 737, if any, on a distribution of money or property to the contributing partner that is part of the same distribution as the distribution of the contributed property. Id.
c. The partnership's basis in the distributed section 704(c) property is increased or decreased immediately before the distribution by the amount of gain which is recognized by the contributing partner. Thus, the increase or decrease in basis is taken into account in determining the distributee partner's basis in the distributed property under section 732. Treas. Reg. § 1.704-4(e)(2).

d. The basis adjustment to the partnership property is not optional, it must be made. Treas. Reg. § 1.704-4(e)(3).

e. Any adjustment necessary pursuant to a section 754 election must be made after the adjustments to basis necessary under this provision. Id.

B. Special Rules

1. If a partnership exchanges section 704(c) property in a nonrecognition transaction, the property received is treated as section 704(c) property to the extent it would be so treated under Treas. Reg. § 1.704-3(a)(8). Treas. Reg. § 1.704-4(d)(1).

2. If a contributing partner transfers his partnership interest, the transferee is treated as the contributing partner for purposes of section 704(c)(1)(B) to the extent of the transferee partner's share of built-in gain or loss. Treas. Reg. § 1.704-4(d)(2).

3. If section 704(c) property is distributed to a noncontributing partner and like-kind property (within the meaning of section 1031) is distributed to the contributing partner, then the amount of gain the contributing partner must recognize under section 704(c)(1)(B) is reduced by the amount of gain inherent in the like-kind property such partner received.

a. The distribution to the contributing partner must occur no later than the earlier of the (i) 180 days following the date of the distribution to the noncontributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's tax return for the tax year in which the distribution to the noncontributing partner occurs. Id.

b. The contributing partner's basis in the property received is determined as if the like-kind properties were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same transaction and is determined without regard to the increase in the contributing partner's basis in his partnership interest as a result of section 704(c)(1)(B).
C. **Anti-abuse Rule**

1. An "anti-abuse rule" states that the provisions of section 704(c)(1)(B) and the regulations thereunder must be applied to take account of the purposes of section 704(c)(1)(B). Treas. Reg. § 1.704-4(f).
   
a. If a principal purpose is to achieve a tax result that is inconsistent with section 704(c)(1)(B), the Commissioner may recast the transaction for Federal tax purposes in order to achieve consistent tax results.
   
b. Whether an inconsistent tax result is achieved is based on all the facts and circumstances.

2. **Example (based on Treas. Reg. § 1.704-4(f)(2) Ex. 1)**
   
a. On January 1, 1993, A, B, and C form partnership ABC as equal partners with A contributing Property A, nondepreciable real property, with a fair market value of $10,000 and an adjusted tax basis of $1,000, and B and C each contributing $10,000 cash. On December 31, 1998, the partners desire to distribute Property A to B in complete liquidation of B's interest in the partnership. If Property A were distributed at that time, A would recognize $9,000 of gain under section 704(c)(1)(B), the difference between the $10,000 fair market value and the $1,000 adjusted tax basis of Property A, because Property A was contributed to the partnership less than seven years before December 31, 1998. With a principal purpose of avoiding such gain, the partners amend the partnership agreement on December 31, 1998, to provide that substantially all of the economic risks and benefits of Property A are borne by B as of December 31, 1998, and that substantially all of the economic risks and benefits of all other partnership property are borne by A and C. The partnership holds Property A until January 5, 2000, at which time it is distributed to B in complete liquidation of B's interest in the partnership.

b. Although the actual distribution of Property A occurred more than seven years after the contribution of the property to the partnership, the steps taken by the partnership on December 31, 1998 are the functional equivalent of an actual distribution of Property A to B in complete liquidation of B's interest in the partnership as of that date. Section 704(c)(1)(B) requires recognition of gain when contributed section 704(c) property is in substance
distributed to another partner within seven years of its contribution to the partnership.

c. The regulations contain no guidance on what constitutes “substantially all the economic risks and benefits.” An allocation and distribution of 99% of the profits, losses and cash flows attributable to Property A to Partner B should not be fatal given that (1) a one percent interest has historically been treated as material in other contexts and (2) the property remains subject to the claims of the partnership’s creditors.

3. **Example (based on Treas. Reg. § 1.704-4(f)(2) Ex. 2)**

a. A, B, and C form partnership ABC on January 1, 1993, to conduct bona fide business activities. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $1,000, in exchange for a 49.5 percent interest in partnership capital and profits. B contributes $10,000 in cash for a 49.5 percent interest in partnership capital and profits. C contributes cash for a 1 percent interest in partnership capital and profits. A and B are wholly owned subsidiaries of the same affiliated group and continue to control the management of Property A by virtue of their controlling interests in the partnership. The partnership is formed pursuant to a plan a principal purpose of which is to minimize the period of time that A would have to remain a partner with a potential acquiror of Property A. On December 31, 1997, D is admitted as a partner to the partnership in exchange for $10,000 cash. On January 5, 2000, Property A is distributed to D in complete liquidation of D’s interest in the partnership.

b. The distribution of Property A to D occurred more than seven years after the contribution of the property to the partnership. However, a principal purpose of the transaction was to minimize the period of time that A would have to remain partners with a potential acquiror of Property A. Treating the seven-year period of section 704(c)(1)(B) as running during a time when Property A was still effectively owned through the partnership by members of the contributing affiliated group of which A is a member is inconsistent with the purpose of section 704(c)(1)(B). The pooling of assets between A and B, on the one hand, and C, on the other hand, although sufficient to constitute ABC as a valid partnership for federal income tax purposes, is not a similar enough arrangement to satisfy the requirements of section 704(c)(1)(B).
tax purposes, is not a sufficient pooling of assets for purposes of running the seven-year period with respect to the distribution of Property A to do. Thus, with respect to the distribution of Property A to D, the seven-year period of section 704(c)(1)(B) is tolled until the admission of D as a partner on December 31, 1997.

c. Many practitioners believe that Treas. Reg. § 1.704-4(f)(2) Ex. 2 is inconsistent with the statute and invalid.

IV. ANTI-MIXING BOWL RULES: SECTION 737

A. Gain Recognition

1. Section 737 provides that if a partner who contributed section 704(c) property receives a distribution of other property (other than money) from a partnership within seven years of the contribution, such partner will recognize gain equal to the lesser of the “excess distribution” or the partner’s “net precontribution gain.”

a. Any gain required to be recognized under section 737 is in addition to any gain recognized under section 731.

b. The character of the gain is determined by reference to the proportionate character of the net precontribution gain.

2. Section 737 and the regulations thereunder apply to the extent that a distribution is to the partner acting in his capacity as partner (within the meaning of section 731). Treas. Reg. § 1.737-1(a)(2). Thus, if a contribution and distribution are properly treated as a “disguised sale” under section 707, then section 737 does not apply.

a. In addition, section 737 does not apply to the extent that section 751(b) applies. Id.

3. Calculation of excess distribution

a. The “excess distribution” equals the excess (if any) of the fair market value of the distributed property over the partner’s basis in his partnership interest. Treas. Reg. § 1.737-1(b)(1).

b. Fair Market Value

(i) Fair market value is the price a willing buyer would pay a willing seller for the property at the time of distribution, neither being under a compulsion to
buy or sell and both having reasonable knowledge of the relevant facts. Treas. Reg. § 1.737-1(b)(2).

(ii) The fair market value assigned by the partnership will be accepted if the value is reasonably agreed upon by the partners in an arm's length negotiation and the partners have sufficiently adverse interests. Id.

c. Basis adjustment

(i) If a distribution subject to section 737 (and any other distribution which is part of the same transaction) results in a basis adjustment, then such adjustment is reflected in the distributee partner's basis in his partnership interest, subject to two exceptions. Treas. Reg. § 1.737-1(b)(3)(i). The exceptions are as follows.

(a) The increase required by section 737(c)(1) for the section 737 gain recognized.

(b) The decrease required by section 733(2) for property distributed to a partner other than property previously contributed by such partner.

(ii) If the section 737 distribution is properly characterized as an advance or draw, then the partner's basis in his partnership interest is determined on the last day of the partnership's taxable year. Treas. Reg. § 1.737-1(b)(3)(ii).

4. Calculation of net precontribution gain

a. Net precontribution gain is the net gain (if any) that a distributee partner would recognize under section 704(c)(1)(B) if all property that had been contributed to the partnership immediately before the distribution had been distributed to a partner other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. Treas. Reg. § 1.737-1(c)(1).

b. Special rules
(i) Property contributed to the partnership on or before October 3, 1989 is not taken into account. Treas. Reg. § 1.737-1(c)(2)(i).

(ii) If a partnership with a section 754 election in effect distributes money as part of the same distribution as the section 737 distribution, then net precontribution gain is reduced by the basis adjustments (if any) made to section 704(c) property contributed by the distributee partner under section 734(b)(1)(A). Treas. Reg. § 1.737-1(c)(2)(ii).

(iii) The transferee of all or a portion of a contributing partner’s partnership interest succeeds to the transferor’s net precontribution gain, if any, in an amount proportionate to the interest transferred. Treas. Reg. § 1.737-1(c)(2)(iii).

(iv) Net precontribution gain is determined after taking into account any gain or loss recognized under section 704(c)(1)(B) (or that would have been recognized except for a like-kind exception) on an actual distribution to a noncontributing partner of section 704(c) property contributed by the distributee partner, if the distribution is part of the same distribution as the distribution to the distributee partner. Treas. Reg. § 1.737-1(c)(2)(iv).

(v) Net precontribution gain is determined without regard to section 704(c)(2) and Treas. Reg. 1.704-4(d)(3) if the property contributed by the distributee partner is not actually distributed to another partner in the section 737 distribution. Treas. Reg. § 1.737-1(c)(2)(v).

5. Character of gain

a. Character of the section 737 gain is determined by, and is proportionate to, the character of the partner’s net precontribution gain. Treas. Reg. § 1.737-1(d).

b. All gains and losses on section 704(c) property are taken into account in determining net precontribution gain according to their character. Id.

c. Character is determined at the partnership level and any character with a net negative amount is disregarded. Id.
d. Character is determined as if the section 704(c) property had been sold by the partnership to an unrelated third party at the time of the distribution and includes any item that would have been taken into account separately by the contributing partner under section 702(a) and Treas. Reg. § 1.702-1(a).

6. **Exceptions**

   a. Section 737 does not apply to a deemed distribution of partnership interests resulting from a termination of a partnership under section 708(b)(1)(B). Treas. Reg. § 1.737-2(a).

      (i) A subsequent distribution of property by the new partnership to a partner who was a partner in the terminated partnership is subject to section 737 to the same extent that a distribution from the terminated partnership would have been subject to section 737. Id.

      (ii) This rule is applicable to terminations occurring on or after May 9, 1997 but may apply to terminations occurring on or after May 9, 1996 if the partnership and its partners apply this rule to the termination in a consistent manner. Id.

   b. Section 737 does not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a new partnership (transferee partnership) in a section 721 exchange followed by a distribution of the transferee partnership interests in liquidation of the transferor partnership as part of the same plan or arrangement. Treas. Reg. § 1.737-2(b)(1).

   c. Section 737 does not apply to a transfer by a transferor partnership of all of the section 704(c) property contributed by a partner to a transferee partnership in a section 721 exchange followed by a distribution of the transferee partnership interests (and no other property) to the partner who contributed the section 704(c) property in complete liquidation of such partner's interest. Treas. Reg. § 1.737-2(b)(2).

   d. Section 737 applies to a subsequent distribution by the transferee partnership to one of its partners that was formerly a partner of the transferor partnership to the same
extent section 737 would have applied to a distribution from the transferor partnership. Treas. Reg. § 1.737-2(b)(3).

e. Section 737 does not apply to an incorporation of a partnership by any method (other than a distribution to the partners followed by a contribution of the property to a corporation) provided the partnership is liquidated as part of the transaction. Treas. Reg. § 1.737-2(c).

7. Basis adjustments: Recovery rules

a. Distributee Partner’s basis

(i) The distributee partner’s basis in his partnership interest is increased by the section 737 gain but not for purposes of determining the amount of gain recognized under section 737(a) or in determining the amount of gain recognized under section 731(a) on a distribution of money in the same transaction. Treas. Reg. § 1.737-3(a).

(ii) The distributee partner’s basis in the distributed property is determined under section 732(a) or (b). The increase in the distributee partner’s partnership interest resulting from the section 737 gain is taken into account in determining the basis of distributed property other than previously contributed property. Treas. Reg. § 1.737-3(b)(1).

(iii) The basis of the previously distributed property is determined as if it were distributed in a separate and independent distribution prior to the section 737 distribution. Treas. Reg. § 1.737-3(b)(2).

b. Partnership’s basis in partnership property

(i) The partnership increases its basis in “eligible property” by the section 737 gain. Treas. Reg. § 1.737-3(c)(1).

(ii) The regulations define eligible property as property that:

(a) Entered into the calculation of the distributee partner’s net precontribution gain;
(b) Has an adjusted tax basis to the partnership that is less than the property's fair market value at the time of distribution;

(c) Would have the same character of gain on a sale by the partnership to an unrelated party as the character of any of the gain recognized by the distributee partner under section 737; and

(d) Was not distributed to another partner in a distribution subject to section 704(c)(1)(B) that was part of the same distribution as the distribution subject to section 737. Treas. Reg. § 1.737-3(c)(2).

(iii) Method of making the basis adjustment. Treas. Reg. § 1.737-3(c)(3).

(a) First, all eligible property of the same character is treated as a single group.

(I) For this purpose, the character of property is determined in the same manner as the character of the recognized gain determined under Treas. Reg. § 1.737-1(d).

(b) Second, the basis increase is allocated among the separate groups in proportion to the character of the section 737 gain.

(c) Third, the basis increase is allocated among the property within each group in the order in which the property was contributed to the partnership, starting with the property contributed first.

(I) The allocation to property equals the difference between the property's fair market value and adjusted tax basis to the partnership at the time of distribution.

(II) For property that was contributed in the same or a related transaction, the basis increase is allocated based on the respective amounts of unrealized
appreciation in such properties at the
time of the distribution.

(iv) Section 754 adjustments. Treas. Reg. § 1.737-
3(c)(4).

(a) Irrespective of whether a section 754
election is in effect, the basis adjustments
must be made; they are not elective.

(b) Any adjustments under section 734(b)
pursuant to a section 754 election (other
than basis adjustments under section
734(b)(1)(A)) must be made after (and must
take into account) the adjustments to basis
made under Treas. Reg. § 1.737-3(a) and
(c)(1).

(c) Basis adjustments under section
734(b)(1)(A) that are attributable to
distributions of money to the distributee
partner that are part of the same distribution
as the distribution of property subject to
section 737 are made before the adjustments
to basis under Treas. Reg. § 1.737-3(a) and
(c)(1).

c. Recovery of increase to adjusted basis

(i) Any basis increase made pursuant to section 737 is
recovered using any applicable recovery period and
depreciation (or other cost recovery) method
(including first-year conventions) available to the
partnership for newly purchased property (of the
type adjusted) placed in service at the time of the
distribution. Treas. Reg. § 1.737-3(d).

B. Distribution of Previously Contributed Property

1. Any portion of the distribution that consists of property previously
contributed by the distributee partner (previously contributed
property) is not taken into account in determining the amount of
the excess distribution or net precontribution gain. Treas. Reg. §
1.737-2(d)(1). This rule is applicable on or after May 9, 1997.

2. Previously contributed property does not include an interest in an
entity that was previously contributed to the partnership to the
extent the value of the interest is attributable to property
contributed to the entity after the contribution of the interest to the partnership. Treas. Reg. § 1.737-2(d)(2).

3. Property received by the partnership in exchange for section 704(c) property in a nonrecognition transaction is treated as the contributed property with regard to the contributing partner to the extent that the property received is treated as section 704(c) property under Treas. Reg. § 1.704-3(a)(8). Treas. Reg. § 1.737-2(d)(3).

4. The distribution of an undivided interest in property is treated as the distribution of previously contributed property to the extent the undivided interest does not exceed the undivided interest (if any) contributed by the distributee partner in the same property. Treas. Reg. § 1.737-2(d)(4).

5. The portion of the undivided interest in property retained by the partnership after the distribution that is treated as contributed by the distributee partner is reduced to the extent of the undivided interest distributed to the distributee partner. Id.

C. Anti-abuse Rule

1. An “anti-abuse rule” provides that the rules of section 737 and the regulations thereunder must be applied in a manner consistent with the purpose of the section. Treas. Reg. § 1.737-4(a).

   a. If a principal purpose of the transaction is to achieve a tax result that is inconsistent with the purpose of section 737, the Commissioner can recast the transaction to achieve tax results consistent with the purpose of section 737.

   b. Whether a principal purpose of the transaction is to achieve an inconsistent tax result is determined based on all the facts and circumstances.

V. DISTRIBUTION OF MARKETABLE SECURITIES

A. Marketable Securities Treated as Money

1. Section 731(a)(1) provides that a partner does not recognize gain on a distribution from a partnership, except to the extent that any money distributed exceeds the partner’s basis in his partnership interest.

2. However, section 731(c)(1) provides that, for purposes of section 731(a)(1), the term money includes marketable securities and such
securities shall be taken into account at their fair market value on
the date of distribution.

3. **"Marketable Securities"**

   a. Marketable securities are “financial instruments and foreign
currencies which are, as of the date of the distribution,
actively traded.” Section 731(c)(2)(A).

      (i) For purposes of section 731(c), a financial
instrument is actively traded (and is thus a
marketable security) if it is of a type that is, as of
the date of distribution, actively traded within the
meaning of section 1092(d)(1).

      (ii) The regulations under section 1092(d)(1) provide
that actively traded personal property includes any
personal property for which there is an established
financial market. Treas. Reg. § 1.1092(d)-1(a).

      (iii) Thus, financial instruments and foreign currencies
for which, as of the date of distribution, there is an
established financial market are actively treaded and
thus marketable securities.

   b. Marketable securities include:

      (i) Any interest in a common trust fund or a regulated
investment company which is offering for sale or
has outstanding any redeemable security of which it
is the issuer;

      (ii) Any financial instrument which is readily
convertible into, or exchangeable for, money or
marketable securities;

      (iii) Any financial instrument the value of which is
determined substantially by reference to marketable
securities;

      (iv) Any interest in a precious metal which is actively
traded unless such metal was produced, used, or
held in the active conduct of a trade or business by
the partnership;

      (v) Interests in any entity if substantially all of the
assets of such entity consists (directly or indirectly)
of marketable securities, money, or both; and
Any interest in an entity not described above but only to the extent the value of such interest is attributable to marketable securities, money, or both. Section 731(c)(2)(B).

c. Definition of substantially all

(i) For purposes of A.3.b.v. above, the regulations provide that substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money or both. Treas. Reg. § 1.731-2(c)(3)(i).

(ii) In addition, an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money or both, if less than 90 percent but more than 20 percent of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money or both. Treas. Reg. § 1.731-2(c)(3)(ii).

(iii) The value of an entity’s assets is determined without regard to any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire an asset with a principal purpose of avoiding or reducing the effect of section 731(c). Treas. Reg. § 1.731-2(c)(4).

d. Financial instruments include stocks and other equity interests, evidences of indebtedness, options, forward or future contracts, notional principal contracts, and derivatives. Section 731(c)(2)(C).

4. **Amount treated as money**

a. All marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed security, for purposes of section 731(c)(3)(B). Treas. Reg. § 1.731-2(b)(1).

b. The amount that is treated as a distribution of money is reduced (but not below zero) by the excess of (i) the
distributee partner’s distributive share of the net gain, if any, which would be recognized if all the marketable securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value; over (ii) the distributee partner’s distributive share of the net gain, if any, which is attributable to the marketable securities held by the partnership immediately after the transaction, determined by using the same fair market value. Treas. Reg. § 1.731-2(b)(2).

c. Under this rule, pro rata distributions do not result in gain recognition where the partnership’s basis in its assets equals the partners’ bases in their partnership interests.

(i) Example: A, B, and C form the ABC Partnership with each partner contributing $1,000 cash. The partnership buys security 1 for $1,000, security 2 for $1,000 and land for $1,000. Thereafter, the values of security 1, security 2, and the land increase to $6,000, $3,000 and $3,000, respectively. The partnership distributes one-third of security 1 pro rata to each partner.

(ii) The amount that is treated as a distribution of money (the fair market value of security 1, or $6,000) is reduced by the excess of the distributee partner’s share of net gain which would be recognized if the partnership sold all marketable securities held by the partnership immediately before the distribution (fair market values of securities 1 and 2, $9,000, less the basis of securities 1 and 2, $2,000, or $7,000); over the distributee partner’s share of net gain attributable to marketable securities held after the distribution (fair market value of security 2, $3,000, less the basis of security 2, $1,000, or $2,000), or $5,000. Thus, the deemed distribution of cash is $1,000. Each partner’s share is $333. Because the deemed cash distribution is not in excess of the distributee partner’s basis in the partnership, gain is not recognized.

d. A partner’s distributive share of net gain is determined:

(i) By taking into account any basis adjustments under section 743(b) with respect to that partner;
(ii) Without taking into account any special allocations adopted with a principal purpose of avoiding the effect of section 731(c); and

(iii) Without taking into account any gain or loss attributable to a distributed security. Treas. Reg. § 1.731-2(b)(3).

5. Except as provided below, section 731(c) does not apply to the distribution of a marketable security if:

a. The security was contributed to the partnership by the distributee partner;

b. The security was acquired by the partnership in a nonrecognition transaction, and the following conditions are met:

   (i) The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction is less than 20 percent of the value of all the assets exchanged by the partnership in the nonrecognition transaction; and

   (ii) The partnership distributed the security within five years of either the date the security was acquired by the partnership or, if later, the date the security became marketable; or

   (iii) The security was not a marketable security on the date the partnership acquired it, and the following conditions are met:

      (a) The entity that issued the security had no outstanding marketable securities at the time the security was acquired by the partnership;

      (b) The security was held by the partnership for at least six months before the date the security became marketable; and

      (c) The partnership distributed the security within five years of the date the security became marketable. Treas. Reg. § 1.731-2(d)(1).

c. This rule is not applicable to the extent that 20 percent or more of the value of the distributed security is attributable
to marketable securities or money contributed (directly or indirectly) by the partnership to the entity to which the distributed security relates after the security was acquired by the partnership. Treas. Reg. § 1.731-2(d)(2).

d. Section 731(c) applies to the distribution of a marketable security acquired by the partnership in a nonrecognition transaction in exchange for a security the distribution of which immediately prior to the exchange would have been excepted under this paragraph (d) only to the extent that section 731(c) otherwise would have applied to the exchanged security. Treas. Reg. § 1.731-2(d)(3).

6. Investment partnerships

a. Section 731(c) does not apply to the distribution of marketable securities by an investment partnership to an eligible partner. Treas. Reg. § 1.731-2(e)(1).

b. Definition of an investment partnership

(i) Section 731(c)(3)(C)(i) defines an investment partnership as a partnership which has never been engaged in a trade or business and substantially all of the assets (by value) of which have always consisted of money; stock in a corporation; notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; foreign currencies; interests in or derivative financial instruments in any assets described herein or in any commodity traded on or subject to the rules of a board or trade or commodity exchange; other assets specified in regulations; or any combination of the foregoing.

(ii) A partnership is not treated as engaged in a trade or business by reason of:

(a) Any activity undertaken as an investor, trader, or dealer in any asset described in section 731(c)(3)(C)(i);

(b) Reasonable and customary management services provided to an investment partnership in which the partnership holds a partnership interest; and
(c) Reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion, or offering of interests in a corporation in which the partnership holds or acquires a significant equity interest provided that the anticipated receipt of compensation for the services, if any, does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity. Treas. Reg. § 1.731-2(e)(3).

(iii) An upper-tier partnership is not treated as being engaged in a trade or business engaged in by, or as holding a proportionate share of the assets of, a lower-tier partnership in which the upper-tier partnership holds a partnership interest if

(a) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and

(b) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership. Treas. Reg. § 1.731-2(e)(4).

c. Definition of an eligible partner

(i) An eligible partner is any partner who, before the date of distribution, did not contribute to the partnership any property other than property described in section 731(c)(3)(C)(i).

(ii) An eligible partner does not include the transferor or transferee in a nonrecognition transaction involving a transfer of any portion of an interest in a partnership with respect to which the transferor was not an eligible partner. Section 731(c)(3)(C)(iii)(I).

(iii) A partner is not treated as a partner other than an eligible partner solely because the partner contributed services to the partnership. Treas. Reg. § 1.731-2(e)(2)(i).
(iv) If the partner has contributed an interest in another partnership to the investment partnership that meets certain requirements, the contributed partnership interest is treated as property specified in section 731(c)(3)(C)(i).

7. **Basis**

   a. The distributee partner's basis in the distributed marketable securities is the basis determined under section 732, increased by any section 731(c) gain recognized. Treas. Reg. § 1.731-2(f)(1)(i).

   (i) Any increase in basis resulting from the recognition of section 731(c) gain is allocated to marketable securities in proportion to their respective amounts of unrealized appreciation in the hands of the partner before such increase. Id.

   b. The basis of the partner's interest in the partnership is determined under section 733 as if no gain were recognized by reason of section 731(c). Treas. Reg. § 1.731-2(f)(1)(ii).

   c. No adjustment is made to the basis of the partnership property under section 734, or any step-up in basis in the distributed marketable securities in the hand of the distributee partner, as a result of the recognition of gain under section 731(c). Treas. Reg. § 1.731-2(f)(2).

8. **Coordination with other sections**

   a. If a distribution results in the application of sections 731(c) and sections 704(c)(1)(B) and/or section 737, the effect of the distribution is determined by applying section 704(c)(1)(B) first, section 731(c) second, and section 737 last. Treas. Reg. § 1.731-2(g)(1)(i).

   b. For purposes of determining section 731(c) gain, the basis of the distributee partner's interest in the partnership includes the increase or decrease in the partner's basis that results under section 704(c)(1)(B) in a distribution that is part of the same distribution as the marketable securities. Treas. Reg. § 1.731-2(g)(1)(ii).

   c. With respect to section 737, a distribution of marketable securities is treated as a distribution of property other than money to the extent the marketable securities are not
treated as money under section 731(c). Treas. Reg. § 1.731-2(g)(1)(iii)(A).

(i) Marketable securities contributed to the partnership are treated as property other than money in determining the contributing partner’s net precontribution gain under section 737(b). Id.

(ii) For purposes of determining the amount of gain recognized under section 731(c), the partner’s basis in his partnership interest does not include the increase in the partner’s basis resulting from section 737(c)(1). Treas. Reg. § 1.731-2(g)(1)(iii)(B).

d. With respect to a partnership termination under section 708(b)(1)(B), the successor partnership will be treated as if there had been no termination for purposes of section 731(c). Treas. Reg. § 1.731-2(g)(2).

B. Anti-abuse Rule

1. An “anti-abuse rule” provides that the rules of section 731(c) and the regulations thereunder must be applied in a manner consistent with the purpose of the section. Treas. Reg. § 1.731-2(h).

a. If a principal purpose of the transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c), the Commissioner can recast the transaction to achieve tax results consistent with the purpose of section 731(c).

b. Whether a principal purpose of the transaction is to achieve inconsistent a tax result is determined based on all the facts and circumstances.

VI. PARTNERSHIP MERGERS AND DIVISIONS

A. New Regulations

1. The partnership merger and division regulations (hereinafter as they apply to mergers referred to as the “Merger Regulations” and as they apply to divisions referred to as the “Division Regulations”) were proposed on January 11, 2000 and finalized on January 3, 2001. The final regulations are contained in Treas. Reg. §1.708-1(c), (d).

2. The new regulations provide helpful guidance on the tax consequences of partnership merger and division transactions. In
addition, in some cases, they create planning opportunities that were not previously available.


4. The new regulations facilitate the following transactional planning techniques:

a. The tax-free division of assets among partners who together control multiple partnerships in circumstances where the partnership “anti-mixing bowl” rules of Sections 704(c)(1)(B) and 737(a) would otherwise trigger taxation.

b. UPREIT OP Unit transactions where some of the partners in the partnership who transfer property want cash, others want OP Units and the “substantiality” rules of Treas. Reg. §1.704-1(b)(2)(iii) present an obstacle.

   (i) “UPREIT” is an acronym referring to an “umbrella partnership real estate investment trust.” In an UPREIT structure, a real estate investment trust holds substantially all of its assets through an Operating Partnership composed of the REIT as general partner and others as limited partners.

   (ii) “OP Units” are partnership interests in the UPREIT Operating Partnership. An “OP Unit transaction” generally refers to a transaction in which property is contributed to the Operating Partnership in exchange for OP Units.

c. Structures for engaging in a partnership “spin off” of certain assets prior to the admission of a new partner.

d. For a discussion of transactional planning techniques using the new regulations, see Blake D. Rubin & Andrea Macintosh Whiteway, *Creative Transactional Planning Using the Partnership Merger and Division Regulations*, 95 J. Tax’n 133 (2001).

B. **Partnership Mergers Prior to the New Regulations**

1. In order for a merger of corporations to be governed by Section 368(a)(1)(A), the transaction must be a merger or consolidation
effected pursuant to the corporation laws of the United States or a State or territory, or the District of Columbia. Treas. Reg. §1.368-2(b)(1).

2. Moreover, in the case of a corporate merger, a relatively elaborate set of Code provisions specifies the extent to which gain is recognized at the corporate and shareholder level, the effect on stock and asset basis, the extent to which tax attributes carry over and other important tax consequences.

3. In contrast, Section 708(b)(2)(A) governing partnership mergers consists of a single sentence, unchanged since its enactment in 1954, that specifies only which partnership, if any, is deemed to continue after the merger.

4. Section 708(b)(2)(A) provides that in the case of a merger or consolidation of two or more partnerships, the resulting partnership is, for purposes of Section 708, considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can be considered a continuation of more than one of the merging partnerships, the resulting partnership is the continuation of the partnership that is credited with the contribution of the greatest dollar value of assets to the resulting partnership. Treas. Reg. §1.708-1(b)(2)(i), prior to amendment by the Merger Regulations.

5. Moreover, if none of the members of the merging partnerships own more than a 50 percent interest in the capital and profits of the resulting partnership, all of the merged partnerships are considered terminated, and a new partnership results. Under Section 706(c), the taxable years of the merging partnerships that are considered terminated are closed.

6. The ability of partnerships to combine by filing articles of merger is a relatively recent feature of state law. For example, Delaware law did not permit limited partnerships to combine by filing articles of merger until 1985. See Del. Code Ann. tit. 6 §17-211, adopted by 65 Del. Laws ch. 188, §1 (1985). Thus, Section 708(b)(2)(A) addressed partnership merger transactions long before state law permitted statutory mergers of partnerships. This fact compelled the conclusion that a partnership merger can take place without the filing of state law articles of merger.

7. In Revenue Ruling 68-289, the Service addressed the tax consequences of a partnership merger. The facts of the ruling state that three existing partnerships (P1, P2, and P3) merged into one
partnership, with P3 continuing under Section 708(b)(2)(A). The ruling does not discuss the fact that, at the time of its issuance, no state law permitted a statutory merger of partnerships. Nor does the ruling describe how the "merger" was effectuated as a matter of state law. Nevertheless, the ruling holds that the two terminating partnerships (P1 and P2) are treated for Federal income tax purposes as having contributed all of their respective assets and liabilities to the resulting partnership (P3), in exchange for a partnership interest in P3. The terminating partnerships (P1 and P2) are then treated as liquidating, with the partners of P1 and P2 receiving interests in P3 in liquidation of P1 and P2 and taking a basis in the P3 interests determined under Section 732(b). Thus, the ruling applies an "assets-over" form for the merger.

C. Partnership Divisions Prior to the New Regulations

1. Neither the Code, the prior regulations relating to partnership divisions nor the Division Regulations define a partnership "division." Nevertheless, partnership divisions are presumably analogous to corporate spin-offs in which, in the simplest case, one corporation divides into two by distributing the stock of another corporation to its shareholders. The tax consequences of corporate spin-offs are generally specified in Code Sec. 355, which as of this writing consists of 3,189 words contained in 172 sentences. In contrast, the Code provision governing partnership divisions consists of a single sentence, unchanged since its enactment in 1954.

2. Code Sec. 708(b)(2)(B) provides that, in the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall be considered a continuation of the prior partnership.

3. Prior to the issuance of the Division Regulations, regulations issued in 1956 elaborated on the statutory rule by providing that, if members of a resulting partnership had interests of 50 percent or less in the prior partnership, the resulting partnership was considered to be a new partnership. Treas. Reg. §1.708-1(b)(2)(ii), prior to amendment by the Division Regulations. If none of the resulting partnerships had members with interests greater than 50 percent in the prior partnership, none of the resulting partnerships were considered continuations and the prior partnership was considered terminated. Id. Finally, the prior regulations provided that where members of a partnership that has been divided do not become members of a resulting partnership that is considered a
continuation of the prior partnership, such members’ interests are considered liquidated as of the date of the division. *Id.*

D. **The Merger Regulations**

1. The Merger Regulations generally provide that the form of a partnership merger accomplished under laws of the applicable jurisdiction will be respected for Federal income tax purposes if the partnership undertakes the transaction in one of two prescribed forms.

   a. The two forms described are the “assets-up form” and the “assets-over form.”

   b. As discussed below, the same forms are also respected for Federal income tax purposes when undertaken in the context of a division.

E. **The “Assets-Up” Form**

1. In the “assets-up form,” the merged partnership considered terminated distributes its assets and liabilities to its partners in liquidation of their partnership interests, and immediately thereafter the partners in the terminated partnership contribute the distributed assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership. Treas. Reg. §1.708-1(c)(3)(ii).

2. The “assets-up form” is respected if that is the state law form and the distributed assets are actually titled to the distributee or the distributee otherwise acquires state law ownership of the assets. *Id.*

F. **The “Assets-Over” Form**

1. In the “assets-over form,” all of the assets and liabilities of the merged partnership considered terminated are treated as contributed to the resulting partnership, in exchange for an interest in the resulting partnership, and immediately thereafter the terminated partnership is treated as distributing the interests in the resulting partnership to its partners in liquidation. Treas. Reg. §1.708-1(c)(3)(i).

2. The “assets-over form” is respected for Federal income tax purposes when that state law form is used.

   a. It is also the characterization that is adopted when there is no state law form for the merger (e.g., if it is accomplished
by filing articles of merger) and when the state law form is the “interests-over” form or a failed “assets-up” transaction. \textit{Id.}

b. The “interests-over” form refers to a transaction in which all of the partnership interests in the merged partnership considered terminated are contributed to the resulting partnership in exchange for partnership interests in the resulting partnership.

G. \textbf{Additional Considerations}

1. Notwithstanding the general rules set forth in the Merger Regulations, the doctrine of substance over form and the step transaction doctrine will apply and the Commissioner may disregard form and recast a series of transactions in accordance with their substance. Treas. Reg. \S 1.708-1(c)(6), \S 1.708-1(d)(6).

2. A resulting partnership considered a continuation with a basis adjustment in property held by the merged partnership considered terminated will continue to have the same basis adjustment with respect to property distributed.

3. When two or more partnerships merge under Section 708, increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under Section 752. Treas. Reg. \S 1.752-1(f), last sentence, as added by T.D. 8925. This rule is taxpayer favorable and may permit gain from being triggered in certain circumstances as a result of shifts in recourse liabilities.

H. \textbf{The Division Regulations}

1. Although the Division Regulations clarify in some respects the determination of which partnership in a division transaction is considered to be a continuation of the prior partnership, they do not make any fundamental changes in that determination. Indeed, they could not, because as discussed above Code Sec. 708(b)(2)(B) governs that determination and has not been changed since its enactment in 1954.

2. Rather, the central function of the Division Regulations is to specify when the state-law form chosen for the division will be respected for Federal income tax purposes, and when it will be recast into a different form for Federal income tax purposes. Whether the state law form of the division is respected for Federal income tax purposes can have a critical effect on the subsequent
application of certain other important rules of Subchapter K, such as the "anti-mixing bowl rules" of Code Secs. 704(c)(1)(B) and 737.

3. Like the prior regulations under Code Sec. 708(b)(2)(B), the Division Regulations provide that upon the division of a partnership, one or more resulting partnerships shall be treated as a continuation of the prior partnership if the members of the resulting partnership or partnerships had an interest of more than 50 percent in the capital and profits of the prior partnership. Treas. Reg. §1.708-1(d)(1).

4. For this purpose, the term “prior partnership” refers to “the partnership subject to division that exists under applicable jurisdictional law before the division” — i.e., the partnership that divides under state law. Treas. Reg. §1.708-1(d)(4)(ii).

5. Likewise, the term “resulting partnership” refers to “a partnership resulting from the division that exists under applicable jurisdictional law after the division and that has at least two partners who were partners in the prior partnership” — again a determination made under state law. Treas. Reg. §1.708-1(d)(4)(iv).

6. Where a prior partnership divides into two partnerships, both partnerships existing after the division are “resulting partnerships.” Id.

7. If a resulting partnership is treated as a continuation of a prior partnership, then the resulting partnership is bound by all pre-existing elections that were made by the prior partnership. Treas. Reg. §1.708-1(d)(2)(ii).

8. The Division Regulations provide that the form of a partnership division accomplished under the laws of the applicable jurisdiction will be respected for Federal income tax purposes if the partnership undertakes the transaction in one of two prescribed forms. As indicated in the discussion of the Merger Regulations, the two forms are the “assets-over form” and the “assets-up form.”

I. The “Assets-Over” Form

1. In the “assets-over form” of a partnership division where at least one resulting partnership is a continuation of the prior partnership, the divided partnership contributes certain assets and liabilities to one or more recipient partnerships in exchange for interests in the recipient partnership(s), and, immediately thereafter, the divided partnership distributes the interests in such recipient partnership(s)
to some or all of its partners in partial or complete liquidation of
the partners' interests in the divided partnership. Treas. Reg.

a. The Preamble to the proposed regulations noted that this
construct involves the newly formed partnership having
only one partner for a moment in time, but indicated that
the entity should nevertheless be classified as a partnership
from the time of its formation. The Preamble noted that the
partnership termination regulations of Treas. Reg. §1.708-
1(b)(1)(iv) also treat the deemed new partnership as a
partnership from its inception notwithstanding that for a
moment in time it has only one owner.

b. The implications of this analysis for situations where a
partnership owns for more than a moment in time all of the
interests in an entity that is disregarded under Treas. Reg.
§301.7701-3 and then distributes the interest to its partners
are unclear. See Rev. Rul. 99-5, 1999-1 C.B. 434, which
arguably implies that such a transfer should be treated as a
transfer of an undivided interest in the assets of the
disregarded entity followed by the formation of a
partnership.

2. For this purpose, the term "divided partnership" refers to the
continuing partnership that is treated, for Federal income tax
purposes, as transferring the assets and liabilities to the recipient
partnership or partnerships. Treas. Reg. §1.708-1(d)(4)(i).

3. Thus, whether a partnership is a "divided partnership" is
determined under Federal income tax law (which may or may not
look to state law). Likewise, the term "recipient partnership"
refers to "a partnership that is treated as receiving, for Federal
income tax purposes, assets and liabilities from a divided
partnership" – also a determination made under Federal income tax

4. In the "assets-over form" of a partnership division where no
resulting partnership is a continuation of the prior partnership, the
prior partnership will be treated as contributing all of its assets and
liabilities to new resulting partnerships in exchange for interests in
the resulting partnerships, and, immediately thereafter, the prior
partnership will be treated as liquidating by distributing the
interests in the new resulting partnerships to the prior partnership’s

J. The "Assets-Up" Form
1. In the “assets-up form” in which the divided partnership is a continuing partnership, the divided partnership distributes certain of its assets and liabilities to some or all of its partners who then contribute such assets and liabilities to a recipient partnership in exchange for interests therein. Treas. Reg. §1.708-1(d)(3)(ii)(A).

2. In the “assets-up form” in which no resulting partnership is a continuation of the prior partnership, the prior partnership distributes certain assets to some or all of its partners in partial or complete liquidation of the partners’ interests in the prior partnership, and immediately thereafter, such partners contribute the distributed assets to a resulting partnership or partnerships in exchange for interests in such resulting partnership or partnerships. Treas. Reg. §1.708-1(d)(3)(ii)(B).

K. Additional Considerations

1. In order for the “assets-up form” to be respected for Federal income tax purposes, the transfer of assets from the prior partnership to its partners must be accomplished in a manner that causes the partners to be treated under state law as the owners of such assets – albeit only for a moment in time. Treas. Reg. §§1.708-1(d)(3)(ii)(A) and (B).

2. If no form for the division is undertaken, or if a form is undertaken that is not respected as the “assets-over form” or the “assets-up form,” then the division will be treated as occurring under the “asset-over form” for Federal income tax purposes. This might occur, for example, if applicable jurisdictional law permitted the division to be accomplished by filing “articles of division.” See, e.g., 15 Pa. Cons. Stat. section 8579.

3. Moreover, if the transaction is recharacterized into the “assets-over form,” then the “direction” of the transaction – i.e., which partnership is treated for Federal income tax purposes as the “divided” partnership that transfers assets and which partnership is treated as the “recipient” partnership that receives them – may not correspond to the state law form of the transactions.

4. As noted above, the “divided partnership” is the continuing partnership that is treated, for Federal income tax purposes, as transferring the assets and liabilities to the recipient partnership or partnerships, either directly (under the “assets-over form”) or indirectly (under the “assets-up form”). Treas. Reg. §1.708-1(d)(4)(i). Moreover, the regulations provide that if the resulting partnership that, in form, transferred the assets and liabilities in connection with the division is a continuation of the prior partnership.
partnership, then such resulting partnership will be treated as the divided partnership.

5. If a partnership divides into two or more partnerships and only one of the resulting partnerships is a continuation of the prior partnership, then the resulting partnership that is a continuation of the prior partnership will be treated as the divided partnership. If a partnership divides into two or more partnerships without undertaking either the “assets-over” or “assets-up form” for the division or if the resulting partnership that, in form, transferred assets and liabilities is not considered a continuation of the prior partnership, and more than one resulting partnership is considered a continuation of the prior partnership, then the continuing resulting partnership with the assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership. Treas. Reg. §1.708-1(d)(4)(i).

VII. INSTALLMENT SALES

A. Section 453 Generally

1. Section 453 provides rules for reporting gain from certain qualifying installment sales of property on the installment method.

2. Where a disposition qualifies as an installment sale, the installment method permits a taxpayer to defer gain recognition on the sale until the taxpayer actually receives the installment payments.

3. Installment sale defined: An installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Section 453(b).

B. Exceptions

1. The installment sale provisions generally do not apply to the following:

   a. A “dealer disposition,” meaning

      (i) Any disposition of personal property by a person who regularly sells or disposes of property of the same type on the installment plan, or

      (ii) Any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer’s trade or business. Section 453(l)(1).
Exceptions are provided for certain dispositions of farm property, timeshares, and residential property. Section 453(l)(2).

b. A disposition of personal property of a kind includable in inventory of the taxpayer. Section 453(b)(2)(B).

c. A disposition for which the taxpayer elects out of section 453. Section 453(d).

d. A disposition of personal property under a revolving credit plan. Section 453(k)(1).

e. An installment obligation arising out of the sale of:

(i) Stock or securities that are traded on an established securities market, or

(ii) To the extent provided in regulations, other property of a kind regularly traded on an established market. Section 453(k).

f. A sale of depreciable property between related persons. Section 453(g)(1).

2. The Tax Relief Extension Act of 1999 amended Section 453(a)(2) to provide that the installment sale provisions would not apply to a disposition if the income from that disposition would otherwise be reported on the accrual method of accounting. This amendment was repealed retroactively in the Installment Tax Correction Act of 2000.

a. Guidance regarding the consequences to taxpayers that filed returns based on the 1999 amendment is contained in Notice 2001-22.

C. **Timing of Income**

1. The amount of income reported with respect to an installment sale and a payment equals the amount of the payment multiplied by the gross profit ratio. Section 453(c).


a. Thus, each payment represents both
a nontaxable recovery of a portion of the seller's basis (investment) in the property, and

(ii) a taxable realization of a portion of the seller's gain.

b. Only the amount of each payment that represents gain must be reported as income.


4. Where property subject to debt is sold on the installment method and the purchaser assumes, or takes the property subject to such debt, the selling price is defined to mean the gross selling price without any reduction for such debt. Temp. Treas. Reg. § 15A.453-1(b)(2)(ii).

5. The "contract price" is the selling price reduced by the amount of any "qualifying indebtedness" assumed or taken subject to by the buyer, to the extent of the seller's basis in the property. Temp. Treas. Reg. § 15A.453-1(b)(2)(iii).

6. The excess of debt assumed or taken subject to over the seller's basis is treated as a payment received in the year of sale. Temp. Treas. Reg. § 15A.453-1(b)(3)(i).

a. In every case where the amount of debt assumed or taken subject to exceeds the seller's basis in the property, the seller will recover its entire basis in the year of sale.

b. Moreover, the amount of debt assumed in excess of basis will be treated as a payment received in the year of sale, thereby increasing gain recognition in the year of sale.

c. In cases where the buyer assumes or takes subject to a mortgage in an amount greater than the seller's basis in the property, the gross profit ratio will always be 100 percent.

D. **Installment Sale with a Wraparound Mortgage**

1. Generally: A wraparound mortgage is an agreement in which the buyer issues to the seller an installment obligation in an amount that effectively includes the seller's outstanding mortgage encumbering the property. As between the buyer and the seller, the seller remains liable for and continues to service the underlying mortgage.
2. Wraparound mortgages provide a mechanism for avoiding the provisions in the installment reporting regulations requiring the treatment of mortgage debt in excess of basis that is "assumed" or "taken subject to" as a deemed payment in the year of sale.

3. In Stonecrest Corp. v. Comm'r, 24 T.C. 659 (1955), nonacq., 1956-1 C.B. 6, the Tax Court concluded that wraparound notes were not subject to the regulations governing "subject to" and "assumed" sales, because by the very nature of the wraparound notes, the buyer neither "assumed" the underlying mortgage nor took "subject" to it.

   (i) In Stonecrest, the seller retained legal title to the property as a security device, agreeing to apply the buyer's installment payments to the underlying mortgage and convey title to the property to the buyer at a future time.

   (ii) The court treated the transaction as a sale for tax purposes notwithstanding the seller's retention of title, but refused to find an assumption of the underlying mortgage or a conveyance subject to it.

   (iii) Accordingly, the excess of the mortgage over the seller's basis was not includable as a payment deemed received in the year of sale.


   a. Under the temporary regulations the buyer under a wraparound mortgage was generally treated as having assumed or taken the property subject to the seller's mortgage, even though title had not passed to the buyer and, as between seller and buyer, the seller remained liable for payments on the mortgage. Temp. Treas. Reg. § 15A.453-1(b)(3)(ii). Therefore, under the Temporary Regulations, where the debt exceeds the seller's basis in the property, such excess was treated as a payment in the year of sale.

In *Professional Equities, Inc. v. Comm'r*, 89 T.C. 165 (1987), the Service challenged the taxpayer's computation of the total contract price where the taxpayer used wraparound mortgages. The IRS argued that the taxpayer must reduce the contract price by the mortgage in accordance with Temp. Treas. Reg. § 15A.453-1(b)(3)(ii).

In holding the temporary regulations as invalid, the Tax Court stated that for installment sales of property with a wraparound mortgage, the buyer should not be treated as taking the property subject to or having assumed the existing mortgage. Therefore, the seller should not have to reduce the total contract price by the amount of the underlying mortgage for the purpose of computing the percentage of a payment reportable as gain. The taxpayer was entitled to report gain from the wraparound sales under the method approved in *Stonecrest*.

The IRS has acquiesced in the Tax Court's decision in *Professional Equities*, AOD, 1988-2 C.B. 1. Nevertheless, the portion of the temporary regulations dealing with wraparound mortgages has not yet been withdrawn.

5. Notwithstanding the holding in *Professional Equities*, there are practical and tax risks associated with using a wraparound mortgage.

a. Installment sales utilizing wraparound mortgages are often difficult to arrange in a satisfactory way because of the difficulty of providing the buyer with adequate assurances that its payments will reduce the underlying first mortgage (which remains a lien on the buyer's property) without causing the wraparound arrangement to fail from a tax perspective.

b. Even if a transaction is characterized as a wraparound mortgage, it will not be taxed as such if in substance the buyer has taken the property subject to the underlying mortgage. This will occur if either the buyer is required to discharge the underlying mortgage or the seller has so little control over disposition of the payments made by the buyer that in fact, the payments are in substance being made directly from the buyer to the first mortgagee. See

c. In Kline v. Comm'r, T.C. Memo. 1989-317, citing Goodman v. Comm'r, the court concluded that the use of a collection account to provide assurances that the buyers payments would in turn be used to service the mortgage indicated that the seller had given up sufficient control over the proceeds of the wraparound note that the buyer must be treated as having assumed the mortgage.

6. Interest Charge: A major disadvantage of using an installment sale with a wraparound mortgage is the application of the interest charge rules. See “Planning Installment Sales: The Interest Charge and Pledge Rules” below.

VIII. PLANNING INSTALLMENT SALES: THE INTEREST CHARGE AND PLEDGE RULES

A. Policy and Historical Perspective

1. From a policy standpoint, the rationale for permitting installment reporting is straightforward: the appropriate time to collect tax on gain from a deferred payment sale is when the taxpayer receives cash and has the wherewithal to make payment to the government.

2. Notwithstanding the simple appeal of installment reporting, its use gives rise to knotty problems from a policy perspective.

   a. To begin with, installment reporting effectively permits a taxpayer to receive an interest-free loan from the government in an amount equal to the unpaid tax due on the sale. As a result, a tax system that permits the unfettered use of installment reporting encourages taxpayers to structure deferred payment rather than cash sales.

   b. For example, assume that B owns property with basis of $0 and value of $1,000. B sells the property for a $1,000 note due one year after the sale with 10 percent interest payable at maturity. Assuming a tax rate of 30 percent and that installment reporting is permitted, at the end of the year B will receive $1,100, will owe tax of $330, and will net $770. On the other hand, if B sold the property for $1,000 cash, she would have $700 in after-tax proceeds to invest. If she used the $700 to buy a one-year certificate of deposit bearing interest at 10 percent, she would earn $70 of interest during the year on which $21 of tax would be due.
Thus, at the end of the year, B would have $749 after payment of taxes. Since the installment sale gives B $770 of after-tax proceeds, while the cash sale gives her only $749, from a tax standpoint she will prefer the installment sale.

c. A second perceived problem (and the one that was the catalyst for the proportionate disallowance rule contained in the Tax Reform Act of 1986) was the ability of taxpayers to receive current cash without incurring tax liability by making an installment sale and pledging the installment obligation for a loan. If the rationale for permitting installment reporting is that tax should be due when a taxpayer has the cash to pay it, installment reporting should not be permitted when a taxpayer “cashes out” in this manner.

d. The Revenue Act of 1987, Pub. L. No. 100-203 (hereinafter the “1987 Act”), addressed these two policy-concerns by imposing an interest charge on the deferred tax attributable to installment sales and by accelerating gain recognition upon the pledge of an installment obligation. While the 1987 Act provisions generally applied only with respect to nondealer sales of real estate, TAMRA extended the scope of the interest charge and pledge rule to include virtually all nondealer installment sales.

B. Installment Sales Affected - Sales After December 31, 1988

1. The interest charge and pledge rules generally apply with respect to installment obligations arising from any nondealer installment sale after December 31, 1988 for more than $150,000. IRC § 453A(b)(1).

2. For purposes of applying the $150,000 threshold, all sales or exchanges which are part of the same transaction (or series of related transactions) are treated as one sale or exchange. IRC §§ 453A(b)(5).

3. Exceptions:

a. Installment sales by an individual of personal use property (e.g., a personal residence) and obligations arising from installment sales of farm property are exempt. IRC §§ 453A(b)(3)(A) and (B).
b. Installment sales of certain residential timeshares are subject to a separate, modified interest charge and are not subject to the pledge rule. IRC § 453A(b)(4) and 453(1)(3).

4. The term “applicable obligations” ("AOs") is used hereinafter to refer to obligations subject to the interest charge and pledge rules under the post-TAMRA rules (to the extent post-TAMRA law is applicable).

C. **Interest Charge**

1. General Rule: If an AO is outstanding at the close of the taxable year, tax for the year is increased by an interest charge computed at the underpayment rate on the "applicable percentage" of the deferred tax liability with respect to the AO. IRC § 453A(c)(1).

2. **$5,000,000 Threshold**

   a. The interest charge does not apply with respect to an AO arising in a taxable year if the total AOs arising in such year that are outstanding at year end do not exceed $5,000,000. IRC § 453A(b)(2).

   b. The applicability of the threshold requirement is determined in the year the AO arises and does not change thereafter regardless of whether more than $5,000,000 of AOs arise in a subsequent year. IRC §§ 453A(b)(2) and 453A(c)(4).

3. **Application to Pass-Through Entities**

   a. In Notice 88-81, 1988-30 I.R.B. 28, the Service indicated that the $5,000,000 threshold is applied at the partner (or S corporation shareholder) level. Notwithstanding Notice 88-81, the instructions to the 1988 Form 1065 and 1120S in some cases stated, and in other cases implied, that the $5,000,000 threshold applied at the partnership (or S corporation) level. However, in Announcement 89-33, 1989-10 I.R.B. 30, the Service announced that taxpayers should follow Notice 88-81 rather than the Forms.

   b. Thus, in general, a partner will not be subject to the interest charge if his "share" of AOs arising in a year, plus any AOs of the partner arising outside the partnership, do not exceed $5,000,000.

   c. The determination of a partner's "share" of AOs will be a complicated matter in all but the simplest partnerships. In
general, it would appear that a partner's share of an AO should be equal to the distributive share of profit attributable to the AO that will be allocated to the partner over the life of the obligation. However, in a partnership where allocations may vary over time based on the operations of the partnership, it may be impossible to determine precisely how much income attributable to the AO ultimately will be allocated to any partner.

d. Where a partner owns more than 50 percent of the interests in profits and capital of a partnership, Section 453A(b)(2) may require aggregation of the AOs of the partnership and the controlling partner. See Rubin and Cavanagh, "Real Estate Installment Sales Under the 1987 Act," 41 Tax Notes 219, 222 (October 10, 1988).

D. Computation of the Interest Charge

1. Computation of the interest charge is done in three steps:

a. Step 1. Compute the deferred tax liability with respect to any AO by multiplying the amount of gain that has not been recognized at year end by the maximum rate of tax in effect for such tax year under Section 1 or 11, whichever is applicable. IRC § 453A(c)(3). In addition, if the gain will be treated as capital gain, the maximum rate on net capital gain under Section 1(h) or 1201 (whichever is applicable) is used instead. Of course, the rate will vary depending on whether the taxpayer is an individual, corporation, estate or trust.

b. Step 2. Multiply the deferred tax by the "applicable percentage" with respect to each AO. The applicable percentage for each AO is the percentage determined by dividing the portion of the aggregate face amount of AOs arising in the taxable year that are outstanding at year end in excess of $5,000,000 by the total face amount of all AOs arising in such year that are outstanding at year end. The applicable percentage is determined in the year the AO arises and remains the same for the life of the AO. IRC § 453A(c)(4).

c. Step 3. Determine the interest charge by multiplying the applicable percentage of the deferred tax liability by the under-payment rate under Section 6621 in effect for the month with or within which the taxpayer's tax year ends. IRC § 453A(c)(2).
2. **Example.**

   a. Assume a taxpayer sells a rental building with a basis of $10,000,000 for a $20,000,000 note, and that no payments are made on the note before the end of the taxable year. The deferred gain on the sale is $10,000,000. Assuming that 39.6 percent is the appropriate tax rate, the deferred tax liability is $3,960,000. If no other AOs arise during the year, the "applicable percentage" would be 75 percent \( \frac{(20,000,000 - 5,000,000)}{20,000,000} \). If the interest rate under Section 6621 for the month with or within which the taxpayer's taxable year ends is 10 percent, the interest charge for the year would be $297,000 \( (3,960,000 \times .75 \times .10) \).

   b. From a planning standpoint, it is important to note that if the $5,000,000 threshold is met, an entire year's interest will be payable with respect to AOs that arise during the year and are outstanding at year end, regardless of the date of sale. Thus, if an installment sale occurs December 31, 1988 and the proceeds are collected on January 1, 1989, an entire year's interest is payable for 1988. No interest would be payable for 1989, since the AO would not be outstanding at the end of 1989. However, since 1989 estimated tax payments generally will take into account the gain on sale, the fact that no interest is due for 1989 can hardly be considered a benefit.

E. **Payment of Interest**

1. Under Section 453A(c)(1), the interest charge is payable in the same manner as tax for the year. This requirement presumably means that the interest charge must be taken into account in making estimated tax payments.

2. Unfortunately, of course, the amount of AOs outstanding at year end—a necessary element of the interest computation—cannot be determined until year end. In addition, the Section 6621 interest rate applicable for the last month of the taxable year cannot be determined until the last quarter of the year. See IRC §§ 6621(b) and 1274(d).

3. Unless the taxpayer can argue (or regulations provide) that the entire interest charge arises on the last day of the year and that the annualized income estimated tax safe harbor therefore applies (see IRC §§ 6654(d)(2) and 6655(e)), the taxpayer may incur estimated
tax penalties as a result of guessing wrong about the amount of the interest charge.

F. **Deductibility of Interest Charge**

1. Section 453A(c)(5) provides that any amount payable under Section 453A(c) shall be taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid or accrued during the year.

2. In the case of individuals, interest on an underpayment of tax is treated as “personal interest,” which cannot be deducted. See IRC § 163(h).

3. For C corporations, the interest charge, like interest on an underpayment of tax, is fully deductible.

G. **The Foreclosure Problem**

1. If the buyer defaults on an AO and the seller forecloses, Section 1038 generally will apply to prevent the seller from recognizing gain on repossession of the property or taking a bad debt deduction.

2. However, Section 1038 does not have any mechanism to account for interest payments the seller previously made to the government with respect to the AO. Since the seller will have paid interest on deferred tax liability attributable to gain that turns out to be illusory, fairness would seem to require that the seller receive a refund of the interest paid. Alternatively, at a minimum, the seller should be permitted to deduct the amount of the interest previously paid or increase the basis of the repossessed property by such amount. Unfortunately, neither the statute nor the legislative history suggests any such result.

3. Similar problems also arise outside of the foreclosure context when the seller disposes of an AO for less than the face amount of the obligation. In such a case, the seller will have paid interest on tax that ultimately is not due. A technical correction to solve these problems clearly is in order.

H. **Contingent Payment Sales**

1. Application of the interest charge to contingent payment sales also poses difficult problems. Treasury Regulations Section 15A.453-1(c) generally sets forth a tripartite regime with respect to installment reporting of contingent payment sales.
a. First, in the case of a sale having a stated maximum selling price, the regulation generally requires that the maximum selling price be used for purposes of computing the gross profit ratio on the sale, with appropriate adjustments made if and when it becomes clear that the maximum selling price actually will not be realized. Treas. Reg. § 15A.453-1(c)(2).

b. Second, in the case of installment sales with no maximum selling price but a maximum period over which payments may be received, the taxpayer’s basis generally is recovered ratably over the taxable years in which payment may be received. Treas. Reg. § 15A.453-1(c)(3).

c. Finally, in the case of contingent payment sales with no stated maximum selling price and no maximum period over which payment may be received, the taxpayer’s basis generally is recovered ratably over a 15-year period. Treas. Reg. § 15A.453-1(c)(4).

2. Integration of the interest charge with the existing rules for reporting contingent payment installment sales that have a stated maximum selling price should not prove particularly difficult. Presumably, the interest charge payable each year will be based on the stated maximum selling price, with appropriate adjustments made if and when it becomes clear that the stated maximum selling price will not be realized.

3. However, imposition of an annual interest charge with respect to contingent payment sales that have no stated maximum selling price is much more difficult.

a. In the case of both contingent payment sales that have a maximum period over which payments may be received and sales that have no such maximum period, the temporary regulations do not require or permit the taxpayer to estimate the total amount of deferred gain on the sale, but rather set forth a method of recovering basis against payments of the sale price as and when received. Absent some estimate ab initio of the total gain on the sale, there simply is no workable way to impose an interest charge on an annual basis.

b. In a related context, regulations under the proportionate disallowance rule require the taxpayer to take into account the fair market value of contingent payments in determining the “outstanding face amount” of an
installment obligation. Treas. Reg. § 1.453C-3T(a)(3). Clearly, in many cases the determination of the value of a contingent payment—particularly one that has no stated maximum amount or outside payment date—will be problematical at best.

c. Informal discussions with Treasury Department officials indicate that they are considering permitting the interest charge on contingent payment sales that have no stated maximum selling price to be paid as and when payments of the sale price are received, rather than on an annual basis. If this rule ultimately is adopted, taxpayers may find that they prefer to structure contingent payment sales with no stated maximum selling price in order to avoid annual payment of the interest charge.

I. Special Rules for Timeshares and Residential Lots

1. With great prescience, the timeshare and resort development community lobbied for and received an election in the 1986 Act to pay interest on the deferred tax liability attributable to installment sales rather than be subject to the proportionate disallowance rule. IRC § 453(1)(3).

a. It applies with respect to dispositions in the ordinary course of the taxpayer’s trade or business to an individual of a timeshare interest in residential real property that does not extend for more than six weeks per year, a right to use specified campgrounds for recreational purposes and any residential lot if the taxpayer (or a related person) is not to make any improvements with respect to such lot.

b. In addition, the installment obligation may not be guaranteed by any person other than an individual. See generally Treas. Reg. § 1.453C-8T. (Since the exception for installment sales of timeshares and residential lots was not substantively changed by the 1987 Act, these regulations should be of continuing validity notwithstanding the repeal of IRC § 453C.)

2. In several respects, the interest charge applicable to installment sales of timeshares and residential lots is considerably more favorable to the taxpayer than the interest charge imposed on AOs.

a. First, the interest charge for timeshares and residential lots is payable only when payment of the purchase price is received, rather than on a yearly basis as for AOs.
b. Second, for timeshares and residential lots, no interest will be due if in the year of collection the seller does not recognize gain because of other losses during the year or net operating loss carryforwards. In contrast, for AOs, interest is payable based on the highest rate under Section 1 or 11 and offsetting losses are irrelevant.

c. Third, the interest rate applicable to installment sales of timeshares and residential lots generally will be lower than the rate applicable to AOs. With respect to timeshares and residential lots, interest is payable at the applicable Federal rate under Section 1274 in effect at the time of the sale, based on the maturity of the obligation. With respect to AOs, interest is payable at the rate in effect under Section 6621 for the month with or within which the taxable year ends. The Section 6621 rate is equal to the Section 1274 short-term rate plus three points and is adjusted quarterly.

3. While the interest charge for installment sales of timeshares and residential lots generally is more favorable to taxpayers, the fact that the interest charge is imposed only when payments of the purchase price are collected also solves a number of problems for Treasury.

a. For example, the problems described above with respect to the operation of the Section 453A interest charge in the context of a foreclosure or disposition for less than face amount of the installment obligation are eliminated.

b. Similarly, the problems relating to contingent payment sales do not arise. Members of the American Bar Association Section of Taxation submitted comments to the Treasury urging that the regime applicable to timeshares and residential lots be adopted for AOs. (See Tax Notes Today Highlights & Documents, July 12, 1988, at 291, reprinting comments on IRC § 453A prepared by members of the Sales and Financial Transactions Committee of the ABA Section of Taxation change.) But it seems clear that this result would require a legislative change.

J. Pledges of Installment Obligations

1. Deemed Payment Rule

a. If an AO is used as security for a loan, the net proceeds of the loan are treated as a payment received on the AO. IRC § 453A(d). Gain accordingly will be recognized on the AO
in an amount equal to the product of the net loan proceeds received and the gross profit ratio applicable to the AO.

b. The $5,000,000 threshold applicable with respect to the interest charge discussed above does not apply in the context of the pledge rule. Thus, any pledge of an AO is subject to the deemed payment rule, regardless of whether $5,000,000 of AOs arise and are outstanding at the end of the taxable year.

c. The deemed payment is treated as occurring on the date the loan becomes secured by the AO or the date that the net loan proceeds are received by the taxpayer, whichever is later. The fact that the AO serves as collateral for the loan for only a brief period or that the loan is repaid quickly is irrelevant. Thus, if a taxpayer pledges an AO with a 30-year maturity as security for a 30-day loan of equal face amount, gain that otherwise would have been deferred for 30 years will be triggered even though the taxpayer only has use of the loan proceeds for 30 days.

d. According to the legislative history of the 1987 Act, the "net proceeds" of the loan (i.e., the amount of the deemed payment) is an amount equal to the gross loan proceeds less the direct expenses of obtaining the loan. H.R. Conf. Rep. No. 100-495, 100th Cong., 1st Sess., at 929 N.7. Neither the statute nor the legislative history make any mention of the possibility of apportioning the net loan proceeds when collateral in addition to an AO is posted as security for the loan.

(i) For example, if an AO with a face amount of $500,000 and other property with a value of $500,000 are used to collateralize a loan the net proceeds of which are $750,000, the entire net loan proceeds may be treated as a deemed payment on the AO, rather than, e.g., $375,000. It is to be hoped that regulations will provide for apportionment in this situation.

(ii) The amount of the net loan proceeds treated as a deemed payment may not exceed the excess of the total contract price of the AO over any portion of the total contract price received before the time the deemed payment arises. IRC § 453A(d)(2). For this purpose, amounts previously treated as received under the deemed payment rule are taken into
account, but amounts actually received that were not taxable under the rule for subsequent payments discussed below are not taken into account. The purpose of this provision is, of course, to ensure that the taxpayer will never be treated as receiving payments on the AO in excess of the total contract price of the AO.

2. **Treatment of Subsequent Payments**

   a. After a deemed payment is received on an AO under the pledge rule, any subsequent actual payments received on the AO result in gain recognition only to the extent that they exceed the deemed payment. IRC § 453A(d)(3).

   b. For example, assume that rental real estate is sold for a $1 million installment note, with $100,000 of principal payable each year for ten years (together with interest at the applicable Federal rate) commencing one year after the date of sale. Assume the property sold had an adjusted basis of $600,000, so that the gross profit ratio is 40 percent. In the year of sale, the AO is pledged as collateral for a loan the net proceeds of which are $800,000. The $800,000 net proceeds are treated as a payment on the AO, resulting in gain recognition of $320,000. However, the first $800,000 of principal payments on the AO may be collected tax free; only the last $200,000 of principal payments will trigger the remaining $80,000 of gain recognition.

3. **Secured Indebtedness**

   a. The deemed payment rule applies if indebtedness is “secured by an installment obligation to which this section applies” (i.e., an AO). Section 453A(d)(4), captioned “Secured Indebtedness,” provides that “indebtedness is secured by an installment obligation to the extent that payment of principal or interest on such indebtedness is directly secured (under the terms of the indebtedness or any underlying arrangements) by any interest in such installment obligation.”

   b. 1999 Legislation: Section 453A(d)(4) was recently amended to provide that a payment shall be treated as directly secured to the extent the taxpayer has the right to satisfy the indebtedness with the installment obligation.
c. Apparently, unperfected security interests may trigger application of the statute.

(i) Section 9.304 of the Uniform Commercial Code provides that a security interest in money or instruments can be perfected only by the secured party's taking possession—i.e., a "pledge" must occur. However, the operative language of IRC § 453A(d) does not require that a pledge take place or that the lender's security interest in the AO be perfected.

(ii) While an earlier legislative incarnation of the pledge rule contained a "general lien exception" which would have disregarded pledges of installment obligations pursuant to a general lien on all the borrower's assets, Section 453A(d) contains no such exception. (See the House version of the 1986 Act, H.R. 3838, 99th Cong., 1st Sess. § 903.) Thus, the pledge of an AO pursuant to a general lien on all of the taxpayer's assets will trigger gain recognition.

d. Furthermore, as noted above, neither the statute nor the legislative history suggests that the net loan proceeds may be apportioned between AOs and other assets. Accordingly, it is possible that regulations will require the net loan proceeds to be "stacked" first against AOs. In such a case, if a taxpayer borrowed $2,000,000 and granted a general lien on its assets consisting of an AO with a face amount of $1,000,000 and $19,000,000 of other assets, all of the gain on the AO would be triggered. This result seems unwarranted, and a regulatory general lien exception would accommodate general business practice without doing violence to the policy of the pledge rule. In addition, as noted earlier, regulations should permit apportionment of the net loan proceeds when collateral other than an AO secures the loan.

4. **Pledges of Entity Interests**

a. Although the concept of "secured indebtedness" appears straightforward on its face, its application in a variety of contexts is unclear.

b. For example, suppose a taxpayer pledges an interest in a partnership or stock of an S corporation owning AOs as
security for a loan. Arguably, regulations should treat the loan as "secured indebtedness" (i.e., as secured by the AOs); failure to do so simply would invite taxpayers to circumvent the statute by contributing their AOs to a passthrough entity and then pledging the interest in the entity. On the other hand, a creditor who has a security interest in a partnership interest or S corporation stock is in a very different position from a creditor who has a security interest in assets of the entity. The former is effectively subordinate to all secured and unsecured creditors of the entity, while the latter has priority over all unsecured creditors and junior liens.

Moreover, Section 453A(d)(4) requires that the indebtedness be "directly secured... by any interest in such obligation." The use of the term "directly" lends credence to the argument that a pledge of an interest in an entity owning an AO should not trigger the statute.

On the other hand, the phrase "any interest in an installment obligation" in IRC § 453A(d)(4) arguably implies that the rule should apply with respect to pledges of ownership interests in entities owning AOs, since such ownership interests would appear to fall within the scope of "any interest" in an installment obligation.

5. **No Security Interest**

a. As noted above, unperfected security interests apparently may trigger application of the statute. Suppose, however, that the lender does not receive even an unperfected security interest, but that all or virtually all of the borrowing entity's assets are AOs. At least absent negative covenants that restrict the ability of the borrower to deal with its own assets, the lack of any security interest under state law should be sufficient to prevent application of the pledge rule.

b. This conclusion is reinforced by the fact that under the House version of the 1986 Act, which would have applied to both "direct" and "indirect" pledges, this arrangement would have been treated as an "indirect" pledge. See H.R. Rep. No. 99-426, 99th Cong., 1st Sess. § 614 (1985). IRC § 453A(d)(4) applies only where the debt is directly secured by the AO.

6. **Definition of Indebtedness**
a. Whether “secured indebtedness” may arise outside of the straight loan context also is unclear.

b. For example, suppose a taxpayer pledges an AO as security for his payment of rent under a lease. The obligation to pay rent under the lease arguably does not constitute an “indebtedness,” except perhaps on the lease payment dates. If the lease obligation nevertheless is treated as an “indebtedness,” are the “net proceeds of the loan” (presumably, the payments due under the lease) treated as received in a lump sum by the taxpayer, or only as the lease payments become due? Assuming that a lease obligation is not treated as an “indebtedness,” taxpayers who might otherwise use the proceeds of borrowings secured by AOs to purchase property may find it advantageous to lease such property and secure the lease by the AOs.

c. A similar issue may arise with respect to loan guarantees. For example, assume a taxpayer guarantees a debt of another, and pledges an AO as security for the guarantee. Presumably, the guarantee does not constitute an “indebtedness” until there is a default on the loan obligation by the primary obligor. Upon a default by the primary obligor, an “indebtedness” may arise, and the pledge rule may apply. On the other hand, the guarantor never received any loan proceeds, and the default by the primary obligor hardly can be viewed as an event which permits the guarantor to “cash out” the AO. Furthermore, accelerating gain upon the occurrence of an event which decreases the guarantor’s ability to pay tax—because he is called upon to discharge the loan obligation—would stand the rationale for the pledge rule on its head.

d. Regulations issued under the now-repealed proportionate disallowance rule generally define “indebtedness” to mean “amounts treated as liabilities for Federal income tax purposes as of the date such amounts are so treated under the taxpayer’s method of accounting.” Treas. Reg. § 1.453C-4T(a).

e. Thus, in addition to loans, promissory notes and other debt instruments, the term “indebtedness” includes liabilities of an accrual basis taxpayer with respect to which the “all events test” has been met and “economic performance” has occurred within the meaning of Section 461(h). Treas. Reg. § 1.453C-4T(a)(2).
f. Even under this relatively inclusive definition, the lease obligation described above would not be treated as "indebtedness" of an accrual basis taxpayer.

(i) With respect to a lease obligation, economic performance occurs as the taxpayer uses the property. IRC § 461(h)(2)(A)(iii).

(ii) As a result, an obligation to pay rent should be treated as "indebtedness" under Treas. Reg. § 1.453C-4T only if the obligation relates to periods of past use of the property—a situation which typically arises only if the lessee is in arrears on the rent.

g. On the other hand, it appears that a loan guarantee given by an accrual basis taxpayer would be "indebtedness" under this rule as of the time the primary obligor defaults, since the "all events test" and "economic performance" standard likely would be met at that time.

h. However, different policy considerations in the context of the pledge rule argue for a narrower definition of "indebtedness" than the one adopted for purposes of the proportionate disallowance rule. In particular, the regulation drafters should bear in mind that the interest charge compensates the government for the deferral caused by installment reporting. As a result, an expansive definition of "indebtedness" in the context of the pledge rule is neither necessary nor appropriate.

IX. CAPITAL GAINS

A. Taxpayer Relief Act of 1997

1. Prior to 1997, there were only two kinds of capital gains – long-term, which were taxed at a maximum of 28 percent, and short-term, which were taxed at ordinary income rates. The Taxpayer Relief Act of 1997, Pub. L. 105-34 ("TRA '97" or the "Act"), made over 800 changes to the Internal Revenue Code of 1986 (the "Code") and added almost 300 new provisions. Among the most significant changes introduced by TRA '97 were the new capital gains rates for individuals. See Section 1(h).

B. IRS Restructuring Bill of 1998

1. Further changes were introduced by the IRS Restructuring Bill of 1998, effective for taxable years ending after December 31, 1997.
2. The main changes include the elimination of "mid-term gains" and the reduction of holding period requirement for the 20% rate to "more than one year."

C. Economic Growth and Tax Relief Reconciliation Act of 2001

1. The 2001 Act added a new 10 percent rate and phases in reductions to the 28 percent, 31 percent, 36 percent and 39.6 percent rates over the next six years. Beginning in 2006, the new rates will be 10 percent, 25 percent, 28 percent, 33 percent and 35 percent.

2. The 2001 Act does not change the maximum rates applicable to long-term capital gains.

D. Current Rate Structure for Individual Capital Gains

1. Short-Term Capital Gains. Gain from the sale or exchange of property held for one year or less remains taxable at ordinary income rates (10 percent to 39.6 percent, subject to the phased-in reductions described above).

2. Mid-Term Capital Gains for taxable years through December 31, 1997. For taxable years ending after 1996 and on or before December 31, 1997, the maximum rate of tax on gain from the sale or exchange of property held for more than one year, but not more than 18 months, was 28 percent.

3. Long-Term Capital Gains. Effective for taxable years ending after 1997, the maximum rate of tax on gain from the sale or exchange of property held for more than one year is 20 percent. If, however, the taxpayer is subject to tax at a 15 percent ordinary income rate, long-term capital gains are taxed at a 10 percent rate.

4. Certain Property with a Five-Year Holding Period.
   a. Gain from the sale or exchange of property held more than 5 years, the holding period for which begins after December 31, 2000, which would otherwise be taxed at a 20 percent rate will be taxed at an 18 percent rate.
   b. Gain from the sale or exchange of property held more than 5 years which would otherwise be taxed at the 10 percent rate will instead be taxed at an 8 percent rate.

   (i) For purposes of determining whether the holding period begins after December 31, 2000, the holding period of any property acquired pursuant to the
exercise of an option (or other right or obligation) shall include the period such option (or other right or obligation) was held.

(ii) A taxpayer holding a capital asset or property used in the trade or business on January 1, 2001, may elect to treat the asset as having been sold on such date for an amount equal to its fair market value, and having been reacquired for an amount equal to such value. If the election is made, the asset will be eligible for the 18 percent rate if sold after being held for more than 5 years after December 31, 2000.

5. **Recapture**
   
   a. Long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate), to the extent the gain would have been treated as ordinary income if the property had been section 1245 property, is taxed at a maximum rate of 25 percent.
   
   b. Gain on real estate, to the extent of depreciation taken in excess of straight-line, is treated as ordinary.
   
   c. Income from discharge of indebtedness that is excluded under section 108 may be applied to reduce basis under section 1017(a)(2). Such reduction is treated as “a deduction allowed for depreciation.” Section 1017(d)(1)(B). When the property the basis of which is reduced under section 1017(a)(2) is sold, gain on the sale will be ordinary to the extent that the depreciation taken, plus the section 1017 basis adjustment, exceed the depreciation that would have been taken using the straight-line method.
   
   d. Section 1231 gain is recharacterized as ordinary income to the extent of section 1231 losses in prior five years. The order of recharacterization is from the highest rate gains to the lowest.

6. **Collectibles.** Long-term gain from the sale or exchange of collectibles (as defined by section 408(m) without regard to paragraph (3) thereof) continues to be taxed at a maximum rate of 28 percent.

E. **Capital Gains Netting Rules**

1. Current netting rules are summarized in IRS Notice 97-59.
2. **Short-Term Capital Gains and Losses**

As under prior law, the order of netting is taxpayer-favorable. Short-term capital losses (including short-term capital loss carryovers) are applied first to reduce short-term capital gains, if any, otherwise taxable at ordinary income rates. A net short-term capital loss is then applied to reduce any net long-term gain from the 28 percent group (collectibles gain), then to reduce gain from the 25 percent group ("unrecaptured section 1250 gain"), and finally to reduce net gain from the 20 percent group (long-term gain also includes the 10 percent rate for long-term gains for low income taxpayers).

3. **Long-Term Gains and Losses**

   a. A net loss from the 28 percent group is used first to reduce gain from the 25 percent group, then to reduce net gain from the 20 percent group.

   b. A net loss from the 20 percent group is used first to reduce net gain from the 20 percent group, then from the 28 percent group and then to reduce gain from the 25 percent group.

4. Long-term loss carryovers always offset the highest rate group first. For individuals, losses do not carry back.

F. **Planning Under the Netting Rules**

   a. Example 1. Assume that, in Year 2, an individual has a 20 percent capital loss of $100,000, a 20 percent capital gain of $100,000 and an unrecaptured section 1250 gain of $100,000. The individual will have $100,000 of adjusted net capital gain which will be taxed at 25 percent.

   b. Example 2. Assume the same facts as in Example 1, except that the 20 percent capital loss of $100,000 is triggered in Year 1 and becomes a capital loss carryover in Year 2. The capital loss carryover will first offset the 25 percent unrecaptured section 1250 gain and then the 20 percent capital gain. Thus, in Year 2, the individual will have $100,000 of adjusted net capital gain which will be taxed at 20 percent. As this example demonstrates, it is important to recognize low rate losses before low rate gains.

   c. Example 3. Assume that, in Year 1, an individual has a 28 percent capital loss of $100,000 (collectibles) and a 20 percent capital gain of $100,000. In Year 2, the individual
has a 28 percent capital gain of $100,000 (collectibles). The individual's capital gains and losses will be offset in Year 1. In Year 2, the individual will have $100,000 of capital gain which will be taxed at 28 percent.

d. Example 4. Assume the same facts as in Example 3, except that the collectibles gain is triggered in Year 1 rather than Year 2. The collectibles gain in Year 1 will be offset by the collectibles loss, and the individual will have $100,000 of adjusted net capital gain in Year 1 taxable at 20 percent. As this example illustrates, the taxpayer is better off recognizing high rate gains and losses in the same year. However, because, in the case of individuals, losses do not carry back, losses should never be recognized after gains.

G. Sale of Partnership Interests to Avoid Recapture

1. Statutory Analysis

a. Substantial confusion has arisen regarding whether sale of an interest in a partnership holding depreciable real estate will result in 25 percent rate gain from “unrecaptured section 1250 gain.”

b. Some have argued that the 25 percent rate can be avoided by selling partnership interests rather than the underlying real estate. This view is based on the fact that there is a specific statutory rule in section 1(h)(6)(B) that requires application of the 28 percent rate to the sale of interests in pass-through entities that own collectibles, but no equivalent rule in section 1(h)(7) with respect to entities that own section 1250 property.

c. Unfortunately, careful analysis of the Code reveals that sale of an interest in a partnership owning depreciable real estate results in 25 percent rate gain to the same extent that 25 percent rate gain would have resulted if the real estate had been sold by the partnership. See sections 1(h)(7)(A), 1250(b)(1), 1250(a), 751(c) (flush language) (cross-referencing sections 1250(a) and 751(a)).

d. Section 1(h)(7)(A) provides that unrecaptured section 1250 gain is determined by reference to “the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent.”
e. Section 751(a) provides that the portion of the gain on a sale of a partnership interest, which is attributable to unrealized receivables, is treated as ordinary income. Section 751(c) (flush language) provides that the term "unrealized receivables" includes section 1250 property, to the extent of the gain which would be subject to section 1250(a) recapture had such property been sold by the partnership.

f. The interplay between sections 751(a) and 751(c) (flush language) makes clear that the gain on the sale of a partnership interest under section 751(a) includes gain which would be realized on a hypothetical sale of the partnership's section 1250 property, to the extent of section 1250(a) recapture. The gain recaptured on the hypothetical sale of the partnership's section 1250 property for purposes of section 751(a) appears to qualify as "the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary" for purposes of the 25 percent rate under section 1(h)(7)(A).

g. It follows that, because (1) the gain on the sale of a partnership interest is determined by reference to the gain recaptured on the hypothetical sale of the underlying section 1250 asset, and (2) the gain recaptured on the hypothetical sale of the underlying section 1250 asset is subject to section 1(h)(7)(A), the gain on the sale of a partnership interest is also subject to section 1(h)(7)(A), to the extent of the depreciation attributable to the underlying section 1250 asset.

h. This statutory analysis is confirmed by the legislative language found in TRA '97. The report of the Joint Committee on Taxation contained the following statement in footnote 76: "[I]n the case of a disposition of a partnership interest held more than 18 months, the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income under section 751(a) if section 1250 applied to all depreciation, will be taken into account in computing unrecaptured section 1250 gain." The same language is also present in footnote 65 in the Senate report to technical corrections provisions of the IRS Restructuring Bill of 1998.

2. **Regulations Under Section 1(h)**
a. Treas. Reg. § 1.1(h)-1(b)(3)(ii) provides that "[w]hen an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, there shall be taken into account under section 1(h)(7)(A)(i) in determining the partner's unrecaptured section 1250 gain the amount of section 1250 capital gain that would be allocated . . . to that partner . . . if the partnership transferred all of its section 1250 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of the interest in the partnership."

b. Basically, this means that the selling partner must take into account an amount equal to his share of the section 1250 gain the partnership would have realized on a hypothetical sale, occurring immediately prior to the actual sale of the partnership interest, in which the partnership sold its section 1250 assets directly.

c. The selling partner's share of the partnership's hypothetical depreciation recapture (determined as if section 1250(b)(1) included all depreciation) is treated as unrecaptured section 1250 gain subject to the 25 percent rate. Prop. Treas. Reg. § 1.1(h)-1(b)(3)(i).

d. The regulations under section 1(h) apply to transfers that occur on or after September 21, 2000.

H. **Constructive Sales**

In general, gain or loss is taken into account for tax purposes when realized. Gain or loss generally is realized with respect to a capital asset at the time the asset is sold, exchanged, or otherwise disposed of. Special statutory rules can defer or accelerate recognition in certain circumstances.

1. Under prior law, it was possible to defer and ultimately avoid recognition of gain on certain appreciated financial positions.

   a. Example: Short Against the Box Transaction. The shareholder borrows shares, usually from a broker, sells the borrowed shares and enters into an obligation to deliver identical shares to the lender. If the shareholder already owns shares identical to the ones borrowed, he is "short against the box." Since the shareholder could either cover using the shares already owned or buy new shares to cover, the basis of the shares used to cover is not known until the position is actually covered. Under section 1001, gain or
loss on the transaction cannot be determined until the taxpayer covers. If the position is covered after the shareholder's death and the taxpayer covers using shares already owned, the shares used to cover get a step-up in basis, and the gain is likely to be avoided.

2. TRA '97, effective June 8, 1997, changed the law by requiring that transactions in “appreciated financial positions” be treated as “constructive sales.” Gain (but not loss) is required to be recognized as if the position were sold at its fair market value as of the date of the constructive sale and immediately repurchased. Section 1259(a)(1). A constructive sale under section 1259 is not a sale for other purposes of the Code.

3. A “constructive sale” of an appreciated financial position occurs if the taxpayer enters into one of the following transactions with respect to the same or substantially identical property: (1) a short sale, (2) an offsetting notional principal contract, or (3) a futures or forward contract to deliver such property. Section 1259(c)(1)(A)-(C).

   a. The term “forward contract” means a contract to deliver a substantially fixed amount of property for a substantially fixed price. Section 1259(d)(1).

   b. The term “offsetting notional principal contract” (or “offsetting NPC”) means, with respect to any property, an agreement which includes:

      (i) a requirement to pay (or provide credit for) all or substantially all of the investment yield (including appreciation) on such property for a specified period, and

      (ii) a right to be reimbursed for (or receive credit for) all or substantially all of any decline in the value of such property.

   c. A short sale is generally a sale to a third party of securities borrowed from another party (the securities lender), with the short seller being under an obligation to deliver identical securities to the lender.

4. **Exceptions**

   a. The term “constructive sale” does not include any contract for the sale of any stock, debt instrument, or partnership interest which is not a marketable security (as defined in
section 453(f)) if the contract settles within 1 year after the 
date such contract is entered into. Section 1259(c)(2).

b. Transactions that are closed before the 30th day after the 
close of the taxable year are not treated as constructive 
sales.

(i) The exception is available only if, for the 60 days 
after closing a transaction, (1) the taxpayer holds 
the appreciated financial position, and (2) at no time 
is the taxpayer's risk of loss reduced (under section 
246(c)(4) principles) by holding certain other 
positions. Section 1259(c)(3)(A).

(ii) If a transaction is closed and then reestablished in a 
substantially similar position, the exception applies 
provided that the reestablished position is closed 
before the end of the 30th day after the close of the 
taxable year and the two requirements above are 
met after such closing. Section 1259(c)(3)(B).

5. The term “appreciated financial position” generally means any 
“position” with respect to any stock, debt instrument or partnership 
interest if there would be gain if such position were sold, assigned, 
or otherwise terminated at its fair market value. Section 
1259(b)(1).

a. The term “appreciated financial position” excludes:

(i) a position that is otherwise marked-to-market (e.g., 
under section 475 or 1256). Section 1259(b)(2)(B).

(ii) A position with respect to debt instruments where: 
(1) the debt unconditionally entitles the holder to 
receive a specified principal amount, (2) the interest 
payments (or other similar amounts) with respect to 
the debt are payable based on a fixed rate or, to the 
extent provided in regulations, at a variable rate, 
and (3) the debt is not convertible either directly or 
indirectly into stock of the issuer or any related 
person. Section 1259(b)(2)(A).

b. The taxpayer's holding period in the position begins anew 
as if the taxpayer had first acquired the position on the date 
of the constructive sale. Section 1259(a)(2)(A).
c. The amount of any gain or loss subsequently realized on the position is adjusted to reflect the gain recognized on the constructive sale. Section 1259(a)(2)(B).

6. **Operating Rules**

   a. If a taxpayer holds multiple positions in property, the determination of whether a specific transaction is a constructive sale and, if so, which appreciated financial position is deemed sold is made in the same manner as actual sales. Section 1259(e)(3).

   b. Where the standard for a constructive sale is met with respect to only a pro rata portion of a taxpayer's appreciated financial position (e.g., some, but not all, shares of stock), that portion will be treated as constructively sold.

   c. If a taxpayer first enters into a short sale, offsetting NPC, or short futures or forward contract, the taxpayer will be treated as making a constructive sale when it subsequently acquires the same (or substantially identical) property as the property underlying the position. Section 1259(c)(1)(D).

   d. Other transactions that have substantially the same effect (i.e., eliminating substantially all of the risk of loss and opportunity for gain) will be treated as constructive sales to the extent provided in regulations. Section 1259(c)(1)(E).

7. To date, no regulations under section 1259 have been issued.

8. **Legislative History of Section 1259**

   a. Congress authorized the Service to issue regulations regarding the following:

      (i) Whether "collar" transactions should be treated as constructive sales.

         (a) The relevant factors for determining whether a "collar" constitutes a constructive sale include: the spread between the put and call prices, the period of the transaction, and the extent to which the taxpayer retains the right to periodic payments on the appreciated financial position (e.g., the dividends on collared stock).
(ii) Whether “in-the-money” options should be treated as constructive sales.

(a) The relevant factors for determining whether an “in-the-money” option constitutes a constructive sale are the same as for collars.

(iii) Whether the taxpayer’s appreciated financial position and his offsetting transaction should be treated on a disaggregated basis, as necessary to reflect economic reality.

(a) For example, disaggregated treatment may be appropriate in an equity swap that references a small group of stocks, where the transaction is entered into by a taxpayer owning only one of the stocks.

(iv) The models for the regulations to be issued by the Treasury may include option prices and option pricing models.

(a) The price of an option represents the payment the market requires to eliminate risk of loss (for a put option) and to purchase the right to receive yield and gain (for a call option).

(b) Thus, option pricing offers one model for quantifying both the total risk of loss and opportunity for gain with respect to an appreciated financial position, as well as the proportions of these total amounts that the taxpayer has retained.

b. The regulations are to be prospective except where necessary to prevent abuse.

c. Equity Collars

(i) Example. Taxpayer holds 1000 shares of ABC stock with a fair market value of $100 per share. Taxpayer buys a put option to sell the stock for $90 per share on a certain date (“the expiration date”). At the same time, Taxpayer sells a call option to Buyer, whereby Buyer obtains the right to buy the stock for $110 per share on the expiration date. If the price paid by Taxpayer for the put option and
the price paid by Buyer for the call option are the same, the collar is "cashless." Taxpayer has no net transaction costs. The collar enables Taxpayer to limit its risk to the window between $90 and $110. Because of the put, Taxpayer bears no risk of loss for a decline in price below $90. On the other hand, because of the call, Taxpayer will not benefit from any increase in price above $110.

(ii) The legislative history contains an example of an equity collar with a put at $95 and a call at $110.

(iii) It is unclear whether the $95/$110 collar was intended to be treated as a constructive sale. However, while such collar was expressly used as an example of an area in which the Treasury should regulate, there is no indication that Congress considered the transaction abusive. Since regulations are to be prospective except where necessary to prevent abuse, a $95/$110 collar should not be treated as a constructive sale prior to the issuance of regulations.

d. The constructive sale provision generally will apply to transactions that are identified as hedging or straddle transactions under other Code provisions. See Sections 1092(a)(2), (b)(2) and (e). See also Sections 1221 and 1256(e).

(i) Where either position in such identified transaction is an appreciated financial position and a constructive sale of such position results from the other position, the constructive sale will be treated as having occurred immediately before the identified transaction. The characterization of the transaction as an identified hedging or straddle transaction will not be affected.

(ii) Where, after the establishment of such an identified transaction, there is a constructive sale of either position in the transaction, gain will generally be recognized and accounted for under the relevant hedging or straddle provision.

9. **Transition Rules for Transactions Occurring Before June 9, 1997**
a. The appreciated financial position, existing prior to June 9, 1997, and the transaction to which the position relates are not taken into account in determining whether another constructive sale has occurred after June 8, 1997, provided that the transaction and the position are clearly identified as offsetting before the close of the 30-day period beginning August 5, 1997, or any later date as specified by Treasury. This special rule will cease to apply when the taxpayer ceases to hold any of the identified positions.

b. In the case of a decedent dying after June 8, 1997, the position and the transaction that gave rise to the constructive sale occurring on or before June 8, 1997 will be treated as property constituting rights to receive income in respect of a decedent.

(i) However, this rule applies only if: (1) the transaction resulting in the constructive sale treatment remains open with respect to the decedent or any related person for at least two years after the date of such transaction; (2) the transaction remains open at any time during the three-year period ending on the date of the decedent's death; and (3) the transaction is not closed within the 30-day period beginning on August 5, 1997.

I. Expansion of Investment Company Exception under Section 351

1. Gain or loss is recognized upon a contribution by a shareholder to a corporation that is an investment company. Section 351(e). Gain, but not loss, is recognized upon a contribution by a partner to a partnership that would be treated as an investment company if it were a corporation. Section 721(b).

2. Prior to TRA '97, a contribution of property was treated as made to an investment company only if (1) the contribution resulted, directly or indirectly, in a diversification of the transferor's interest, and (2) the transferee was (a) a regulated investment company ("RIC"), (b) a real estate investment trust ("REIT") or (c) a corporation more than 80 percent of the assets of which by value (excluding cash and non-convertible debt instruments) were readily marketable stocks or securities or interests in RICs or REITs that were held for investment. Treas. Reg. § 1.351-1(c)(1).

3. In response to planning opportunities available under prior law, TRA '97 modified the definition of an investment company to include the following assets in applying the 80 percent test:
a. Money; stocks and other equity interests in a corporation; evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives; foreign currency; and interests in precious metals unless used or held in an active trade or business after the contribution;

b. Interests in a RIC, REIT, common trust fund, publicly-traded partnership (PTP) (as defined in section 7704(b)) or any other equity interest in a noncorporate entity that is convertible into or exchangeable for one of the other listed assets;

c. Interests in an entity substantially all the assets of which (90 percent) are listed assets, and to the extent provided in regulations, interests in other entities, but only to the extent of the value that is attributable to listed assets.

4. Treasury has regulatory authority to remove items from the list in appropriate circumstances. Section 351(e)(1) (flush language).

5. The following factors remain the same as under prior law:

a. Only assets held for investment are considered for purposes of the definition (Treas. Reg. § 1.351-1(c)(3)).

b. Assets of a subsidiary are treated as owned proportionally by a parent owning 50 percent or more of its stock (Treas. Reg. § 1.351-1(c)(4)).

c. Any plan with regard to an entity's assets in existence at the time of transfer must be taken into account in determining whether the company is an investment company (Treas. Reg. § 1.351-1(c)(2)).

d. A contribution of property to an investment company is taxable only if it results in diversification (Treas. Reg. § 1.351-1(c)(1)(i)).

6. The provision is effective for transfers after June 8, 1997, in taxable years ending after such date, with an exception for transfers pursuant to certain binding written contracts in effect on that date.

J. **Contract Terminations and Debt Retirement**

1. **Contract Terminations**
The definition of capital gains and losses in section 1222 applies if there is a "sale or exchange" of a capital asset. Court decisions interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss.

2. However, under section 1234A, gains and losses attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to certain personal property are treated as gains or losses from the sale of a capital asset.

3. Prior to TRA '97, personal property subject to this rule was (1) personal property (other than stock that is not part of straddle or of a corporation that is not formed or availed of to take positions which offset positions in personal property of its shareholders) of a type which is actively traded and which is, or would be on acquisition, a capital asset in the hands of the taxpayer and (2) a section 1256 contract which is capital asset in the hands of the taxpayer.

4. Prior law resulted in disparate treatment of economically equivalent transactions, such as selling or settling a contract. In response, TRA '97 extended the sale or exchange treatment of section 1234A to the cancellation, lapse, expiration or other termination of a right or obligation with respect to any property, provided the property is (or on acquisition would be) a capital asset in the hands of the taxpayer.

5. As a result of the change, section 1234A applies to:
   a. Amounts received to release a lessee from a requirement that the premises be restored on termination of the lease; and
   b. Non-actively traded personal property, such as the forfeiture of a down payment under a contract to purchase stock.

6. TRA '97 did not affect the determination of whether a right is "property," or whether property is a "capital asset." Likewise, the Act did not address the issue of when and whether a payment should be treated as a cancellation, lapse, expiration or other termination of a right or obligation with respect to property.

7. **Retirement of Debt Obligations**
   a. Amounts received on the retirement of any debt instrument are treated as amounts received in exchange therefor.
Section 1271(a)(1). In addition, gain on the sale or exchange of a debt instrument with original issue discount ("OID") generally is treated as ordinary income to the extent of its OID if there was an intention at the time of its issuance to call the debt instrument before maturity. Section 1271(a)(2).

8. TRA '97 extended section 1271 to debt obligations issued by natural persons after June 8, 1997. As a result, gain or loss on the retirement of such debt will be capital if the debt itself is a capital asset, unless the basis of the debt instrument to the transferee is determined in whole or in part by reference to the adjusted basis of that instrument in the hands of the transferor prior to June 8, 1997.

9. Section 1271 does not apply to debt issued before July 2, 1982, by a noncorporate or nongovernmental issuer.

K. Developing without Dealing: Dealer vs. Investor

1. "[P]roperty held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" is excluded from the definition of a capital asset. Section 1221(1). Thus, gain from the sale of such property is taxable as ordinary income rather than capital gain. A "dealer" is a taxpayer who holds property described in section 1221(1).

2. The following factors are generally relevant to determining whether an asset is a capital asset. See U.S. v. Winthrop, 417 F.2d 905 (5th Cir. 1969).
   a. The nature and purpose of the acquisition of the property and the duration of the ownership;
   b. The extent and nature of the taxpayer’s effort to sell the property;
   c. The number and substantiality of the sales;
   d. The extent of subdividing, developing and improving the property;
   e. The use of a business office and advertising in achieving sales;
   f. The character and degree of control exercised by the taxpayer over the person actually selling the property;
g. The time and effort the taxpayer habitually devotes to the sale of the property.

3. These multiple factors have been distilled into the following three-prong test. See Suburban Realty Co. v. U.S., 615 F.2d 171 (5th Cir. 1980), cert. denied, 449 U.S. 920 (1980).
   a. Whether the taxpayer was engaged in a trade or business, and, if so, what business;
   b. Whether the taxpayer was holding the property primarily for sale in that business;
   c. Whether the sales were "ordinary" in that business.

4. The term "trade or business" is not defined in the Code or the Regulations. The determination of whether the taxpayer is engaged in a trade or business is made from the facts and circumstances of each case. See, e.g., Sanders v. U.S., 740 F.2d 886 (11th Cir. 1984) (holding that the taxpayer, averaging about 15 sales a year, is engaged in a trade or business). The taxpayer may be engaged in more than one trade or business; thus, even individual taxpayers selling real estate on the side may be denied capital gains treatment. See, e.g., Friend v. Commissioner, 198 F.2d 285 (10th Cir. 1952) (lawyer with a broker's license held to be dealer).
   a. Frequent and substantial sales almost automatically translate into the finding that the taxpayer is engaged in a trade or business. See Suburban Realty, supra (more than 200 individual sales in prior years). Courts also look at whether the activity is continuous, and whether the income derived from the activity is substantial. Reese v. Commissioner, 615 F.2d 226 (5th Cir. 1980) (holding that the taxpayer's purchase and improvement of the land was an isolated nonrecurring venture not eligible for ordinary loss); Adam v. Commissioner, 60 T.C. 996 (1973).
   b. Extensive improvements to the property are strongly indicative of a trade or business. Biedenharn Realty Co. v. U.S., 526 F.2d 409 (5th Cir. 1976), cert. denied, 429 U.S. 819 (1976) (holding that the taxpayer who subdivided the land into more than 477 lots, which were held for sale, was a dealer).

5. The determination of whether the taxpayer was "holding property primarily for sale" is made on the basis of the following factors:

   (i) Only the "most important" or "principal" activities count toward determining purpose. *See Malat v. Riddell*, 383 U.S. 569 (1966) ("primarily" means of first importance or principally).

   (ii) A changed purpose overrides the original purpose. *Biedenharn Realty Co.*, supra. However, if the sale to customers was induced by unanticipated external factors and the taxpayer's original purpose in holding the property was investment, the sale may still qualify for capital gains treatment. *Id.*

b. The extent of solicitation, advertising and brokerage activities. *Biedenharn Realty Co.*, supra.

   (i) It is immaterial whether the taxpayer engages in such efforts directly or indirectly. *Sanders*, supra.

   (ii) However, disposition through independent brokers may help preserve the original investment motive of the acquisition. *Estate of Barrios v. Commissioner*, 265 F.2d 517 (5th Cir. 1959).

c. The holding period.

   (i) Generally, the longer the holding period, the more likely capital gains treatment. *See Malat*, supra.

6. The sales are made in the "ordinary course of business" if they are usual rather than abnormal or unexpected. *Suburban Realty Co.*, supra; *Reithmeyer v. Commissioner*, 26 T.C. 804 (1956).

L. **Obtaining Capital Gains Treatment Despite Dealer Status**

1. **Holding for Investment**

   a. Dealers may obtain capital gains treatment with respect to a particular property if they can prove that the property was held for investment. *Murray v. Commissioner*, 370 F.2d 568 (4th Cir.), cert. denied, 389 U.S. 834 (1967); *Pritchett v. Commissioner*, 63 T.C. 149 (1974) acq. 1975-2 C.B.2. In order to establish investment purposes, the taxpayer may do any of the following: (1) document nondealer purposes with respect to a particular property; (2) hold particular
2. **Section 1237**

a. A taxpayer, other than a C corporation, may obtain capital gains treatment with respect to real property subdivided for sale, if the following requirements of section 1237 are met:

(i) The property at issue has not been held by the taxpayer primarily for sale to customers in the ordinary course of business.

   (a) "Primarily for sale" is determined as described in II.A.5.

   (b) Joint ownership or ownership through a partnership is attributed to the taxpayer. Treas. Reg. § 1.1237-1(b)(3).

   (c) Ownership by members of the taxpayer's family, an estate or trust, or a corporation is not attributed to the taxpayer. Id.

(ii) The taxpayer is not a dealer with respect to any other real property in the year of the sale.

(iii) The property has not been substantially improved.

   (a) The permissible extent of improvements is provided in Treas. Reg. § 1.1237-1(c). Improvements made by members of the taxpayer's family, by a corporation controlled by the taxpayer, by a lessee with income to the taxpayer, or pursuant to a contract with the buyer, will be attributed to the taxpayer. Treas. Reg. § 1.1237-1(c)(2)(i), -1(c)(2)(iii).

   (b) Improvements count against the taxpayer only if such improvements substantially enhance the value of the lot sold. Treas. Reg. § 1.1237-1(c)(3).
(c) Increase of less than 10% is per se insubstantial; otherwise, a facts and circumstances test applies. Treas. Reg. § 1.1237-1(c)(3)(ii).

(iv) The property, other than property acquired by inheritance or devise, has been held by the taxpayer for at least five years.

b. Only the first five properties meeting the section 1237 requirements receive full capital gains treatment. A portion of the gain realized on the sale of subsequent properties may be recharacterized as ordinary income. Treas. Reg. § 1.1237-1(e).

3. **Sale to Unrelated Party**

a. A dealer may obtain capital gains treatment by selling undeveloped real property to an unrelated party and retaining an interest in such property. When such property is ultimately sold to customers, the dealer will receive capital gains treatment on the portion of the gain attributable to the pre-development appreciation, and ordinary income treatment on the rest of the gain.

b. Example. Taxpayer obtained a 5-year option to purchase Blackacre. After holding the property for 4 1/2 years, Taxpayer received an offer to purchase Blackacre and a check for $x from Offerors. Taxpayer sold the option to Accountant who exercised the option and sold a portion of Blackacre to Offerors. Accountant continued to sell various parcels of Blackacre thereafter, paying the purchase price of the option from the proceeds of the sales. Taxpayer’s gain on the sale of the option to Accountant is properly reported as long-term capital gain. [fact pattern from Anders v. Commissioner, 68 T.C. 474 (1977)]

c. The buyer must be an unrelated party to avoid the application of sections 1239 and 707.

d. **Section 1239**

(i) Section 1239(a) provides that, in the case of a sale or exchange of depreciable property between related persons, any gain recognized to the transferor must be treated as ordinary income.

(ii) Section 1239(b) defines related persons as:
(a) a trust of which the taxpayer or his spouse is the beneficiary; or

(b) an entity controlled by the taxpayer.

(iii) The term "controlled entity," as defined in section 1239(c), cross-referencing section 267(b), includes:

(a) a corporation if more than 50% of the value of stock is owned directly or indirectly by the taxpayer;

(b) a partnership if more than 50% of the capital or profits is owned directly or indirectly by the taxpayer;

(c) a controlled group of corporations, using the 50% definition of control;

(d) a corporation and a partnership if the same persons own more than 50% of the stock and more than 50% of the capital interest, or the profits interest, in such corporation and partnership, respectively;

(e) an S corporation and another S corporation if the same persons own more than 50% of the value of the outstanding stock of each corporation.

e. Section 707

(i) Section 707(b)(2) provides that, in the case of a sale or exchange of property to a controlled partnership, any gain recognized to the transferor is ordinary income if the property in the hands of the transferee is property other than a section 1221 capital asset.

(ii) A controlled partnership is defined as a partnership in which the selling partner owns more than 50% of the capital interest or profits interest, or two partnerships in which the same person owns more than 50% of the capital interest or profits interest. Section 707(b)(2).

f. Installment Sales
(i) A sale of depreciable property to an entity controlled by the transferor, or between controlled entities, cannot be reported under the installment method. Section 453(g)(1)(A). The term "controlled" for purposes of section 453(g) is defined in sections 1239(b) and 707(b)(1)(B) or 707(b)(2)(B).

(ii) If property is sold to a related person in an installment sale (the "first disposition"), and the transferee resells such property within two years of the first disposition (the "second disposition"), the amount realized with respect to the second disposition is treated as received at the time of the second disposition by the transferor making the first disposition. Section 453(e)(1). The term "related person" for purposes of section 453 is defined in sections 318(a) and 267(b).

4. Collapsible Corporations

a. Instead of employing a corporate entity to develop and sell a physical asset, as described above, the taxpayer might contribute undeveloped real property to a new or existing corporation and then sell the appreciated stock in such corporation. If the corporation is an S corporation, the purchaser may be able to obtain a step-up in basis in the assets at no net tax cost by liquidating the S corporation. Ordinarily, gains on a sale of stock are taxed at capital gains rates. However, if the assets of the corporation consist of property described in section 341, capital gains treatment on the sale or redemption of stock in such corporation is generally precluded.

b. Section 341 applies to "collapsible corporations." A collapsible corporation is a corporation formed or availed of principally for the manufacture, construction, or production of certain property, or for the purchase of certain property, or for the holding of stock in a corporation so formed or availed of, with a view toward selling or exchanging the stock in such corporation at capital gains rates before at least two-thirds of ordinary income attributable to such property has been recognized by the corporation. Section 341(b); Treas. Reg. § 1.341-5(b)(2), (4), (5).
(i) The determination of collapsibility is made on the basis of all the facts and circumstances and is subject to numerous regulatory presumptions. Treas. Reg. § 1.341-5(c).

c. Property covered by section 341 includes property held for less than three years which is:

(i) Stock in trade, or other property which qualifies as inventory;

(ii) Property held primarily for sale to customers in the ordinary course of business;

(iii) Unrealized receivables or fees, except those received not in the ordinary course of business;

(iv) Section 1231(b) property.

d. Section 341 property is deemed to be manufactured, constructed, produced or purchased if:

(i) Such property was manufactured, constructed, produced or purchased by the corporation, regardless of the extent of the corporation’s involvement in such activities; or

(ii) The property’s basis is determined by reference to the basis of the property so manufactured, constructed, produced or purchased.

(a) The enhancement in value of the “constructed” property is relevant to the determination of whether sufficient “construction” occurred. See Smith’s Estate v. Commissioner, T.C. Memo 1977-433 (purchase of land and rezoning not enough); Thomas v. Commissioner, T.C. Memo 1981-387 (same). See also Rev. Rul. 63-114, 1963-1 C.B. 74 (alterations of an existing structure do not amount to “construction” unless there is a significant enhancement in the value of the structure or an appreciable increase in the net income derived therefrom).

e. Transactions covered by section 341 include:
(i) The sale or exchange of stock;

(ii) A distribution in complete or partial liquidation;

(iii) A distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock. Section 301(c)(3)(A).

f. A corporation is presumed to be collapsible if, at the time of the covered transaction, section 341 assets constitute 50% or more of the total value of the corporation's assets and 120% or more of the adjusted basis of all the assets. Section 341(c).

g. Section 341 does not apply to the taxpayers if:

(i) The taxpayer's direct or deemed ownership is less than 5% in value of the outstanding stock of the corporation.

(ii) Less than 70% of the gain realized during a taxable year is attributable to "constructed" property.

(iii) The gain is realized after the expiration of three years following the manufacture, construction, production or purchased of covered property.

(iv) The taxpayer satisfies the numerical formula provided in section 341(e).

(a) Section 341(e) provides that the sum of the net unrealized appreciation in section 341 assets and a certain amount determined by the percentage of the taxpayer's ownership in the corporation cannot exceed 15% of the net worth of the corporation.

(v) The corporation makes an election under section 341(f) agreeing to recognize ordinary income on the disposition of any property being manufactured, constructed, produced or purchased.

5. Collapsible Partnerships

a. Instead of employing a corporation, the taxpayer might contribute undeveloped real property to a new or existing partnership and then sell the partnership interest. Ordinarily, a sale of a partnership interest results in a
capital gain or loss. However, if the assets of the partnership consist of property described in section 751, capital gains treatment on the sale or exchange of an interest in such partnership is generally unavailable.

b. Partnerships to which section 751 applies are often referred to as “collapsible partnerships.”

c. Property covered by section 751 includes:

(i) Unrealized receivables of the partnership;

(ii) Inventory items of the partnership.

(a) Inventory is defined, inter alia, as property held for sale to customers in the ordinary course of business. The application of section 751 to a partnership with real estate holdings depends on whether the partnership is a dealer in real property.

(b) Dealer status is determined as described in II.A.

d. Transactions covered by section 751 include:

(i) Sales of a partnership interest to third parties or to other partners. Section 751(a).

(a) Important: for sales or exchanges after August 5, 1997, section 751 applies even if the partnership’s inventory items are not substantially appreciated. TRA of 1997, Section 1062(a), Pub. L. 105-34, 105th Cong., 1st Sess., approved Aug. 5, 1997.

(ii) Distributions by the partnership which alter the distributee partner’s pro rata ownership of either section 751 property, or other property. Section 751(b).

(a) Section 751(b) applies to such distributions only if the partnership’s inventory items are substantially appreciated. Section 751(b)(1)(A).

(b) Inventory items are considered to be substantially appreciated if their fair market
value exceeds 120% of the partnership’s adjusted basis in such property. Section 751(b)(3)(A).

(c) Section 751(b) does not apply to:

(I) property contributed by the distributee partner;

(II) distributions to a retiring or deceased partner which are governed by section 736(a); or

(III) pro rata distributions of section 751 assets. See P.L.R. 9620020 (Feb. 15, 1996).

(A) However, such assets remain “tainted” in the distributee partner’s hands for five years. Section 735(c).

(d) If section 751(b) applies, the partnership and the distributee partner are each taxed on the difference between the fair market value and the basis of the property relinquished by each to the other. The gain or loss is computed separately with respect to section 751 property, and other property. The character of the gain depends on the character of the asset relinquished.

e. Section 751(f) provides a look-through rule for tiered partnerships.

M. Planning to Extend Holding Periods: Tacking of Holding Periods — Formation of a Partnership

1. Section 1223(1) provides that the holding period of a partnership interest includes the holding period of any capital asset or section 1231 asset contributed to the partnership in a nonrecognition transaction in exchange for an interest in a partnership.

a. Tacking is only permitted for capital assets and section 1231 property.

b. Tacking is permitted for capital assets regardless of how long the partner held the capital asset. However, tacking
for section 1231-type property is not permitted if the
partner held the property for one year or less. (Section
1231 property does not include property held for one year
or less. Section 1231(b)).

2. If a partnership interest is acquired for cash, the partner’s holding
period of the partnership interest begins the day after the purchase.
C.B. 188. See also Treas. Reg. § 1.1223-3.

3. The partnership’s holding period for contributed assets includes the
holding period of the contributing partner. Section 1223(2). See
also, Treas. Reg. § 1.723-1; Rev. Rul. 99-5.

4. In light of these holding period provisions, a partner can have a
split holding period with respect to its partnership interest.

N. Dispositions of Partnership Interests

1. Under Rev. Rul. 84-53, a partner has a unitary basis in its
partnership interest. This means that dispositions of partnership
interests are generally treated differently than dispositions of
corporate stock. For purposes of basis allocation, a selling partner
cannot specifically identify the interest sold. Thus, a partner with a
split holding period in its interest must treat every sale of its
interest as the sale of a long-term asset and a short-term asset.
Treas. Reg. § 1.1223-3(c)(2)(ii).

a. An exception is provided for interests in certain publicly
traded partnerships. Treas. Reg. 1.1223-3(c)(2)(i).

b. A partner may avoid the necessity of splitting holding
periods by holding assets with different holding periods in
different entities.

2. Once the partnership interest is acquired, the partnership’s holding
period governs the determination of whether gain on the sale of
partnership assets is long-term or short-term, regardless of the
partner’s holding period in his partnership interest. See, e.g., Rev.
Rul. 68-79, 1968-1 C.B. 310 (partner received long-term capital
gain treatment on the partnership’s sale of an asset although he
held the partnership interest for less than 6 months).

O. Distributions From a Partnership

1. Basis Adjustments
a. A partnership making a distribution of money or partnership property to a partner may elect to adjust the basis of the remaining partnership property. Section 754.

b. If a section 754 election is made, the partnership is entitled to increase, or decrease, as the case may be, the adjusted basis of partnership property by the amount of any gain, or loss, recognized by the distributee partner. In the case of a distribution of property other than money, the adjustment equals the difference between the adjusted basis of the distributed property to the partnership immediately before the distribution and the basis of the distributed property to the distributee partner. See Section 734(b).

c. No authorities appear to address the partnership’s holding period in the basis adjustment.

2. **Holding Period in Distributed Property**

a. In a distribution of property to a partner, the partner’s holding period in the property includes the partnership’s holding period. Section 735(b); Treas. Reg. § 1.735-1(b). If the property was previously contributed by another partner, then the distributee partner’s holding period will include the holding period of the contributing partner. Treas. Reg. § 1.735-1(b).

P. **Treas. Reg. § 1.1223-3**

1. On a sale or exchange of the partner’s entire interest in a partnership, the partner is required to divide the capital gain or loss recognized on such sale or exchange between long-term and short-term capital gain or loss in the same proportions as the holding period of the interest in the partnership is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less. Treas. Reg. § 1.1223-3(c)(1).

2. On a sale or exchange of a portion of a partnership interest, other than an interest in a publicly traded partnership (as defined in section 7704(b)), the selling partner is required to divide the holding period of the transferred interest between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the selling partner would realize if the entire interest in the partnership were transferred in a fully taxable transaction immediately before the actual transfer. Treas. Reg. § 1.1223-3(c)(2).
3. In the case of publicly traded partnerships, as defined in section 7704(b), the selling partner can use the actual holding period of the identifiable portion being sold. Treas. Reg. § 1.1223-1(c)(2)(i).

4. On a distribution of partnership property to a partner, the distributee partner is required to divide the capital gain or loss recognized on such distribution between long-term and short-term capital gain or loss in the same manner that a gain or loss would be divided if the partner transferred this entire partnership interest in a taxable transaction. Treas. Reg. § 1.1223-3(d)(2).

5. Holding periods are determined as follows: "the portion of a partnership interest to which a holding period relates is determined by reference to a fraction that is (1) the fair market value of the portion of the interest received in the transaction to which the holding period relates over (2) the fair market value of the entire interest (determined immediately after the transaction)." Treas. Reg. § 1.1223-3(b).

   a. Example. On January 1, year 1, Partner acquires an interest for $1,000. On January 1, year 2, Partner makes an additional contribution of $1,000. The value of the original interest is still $1,000 at the time of the second contribution. Subsequently, the partnership interest increases in value, and on July 1, year 2, Partner sells his interest for $3,000. The $1,000 gain recognized by Partner gets bifurcated into long-term and short-term gain 50/50.

6. Determining holding periods based on the value of partnership interests at the time of contribution has the advantage of simplicity. However, it may not always match economic reality, and may create planning opportunities and pitfalls.

   a. Example 1. In Year 1, Partners A and B form Partnership by making equal contributions of property with a basis of $10 and a fair market value of $10. The contributed property appreciates in value, so that, by Year 2, each interest in Partnership is worth $90. In Year 2, A and B each contribute an additional $10 to Partnership capital. As a result of the contribution, both A and B have a new holding period in the portion of each Partner's interest attributable to the Year 2 contribution. That portion equals 10%. If either of the Partners sells his Partnership interest in Year 2, 90% of the gain will be long-term capital gain, but 10% will be short-term capital gain. This result seems inappropriate because if Partnership sold all of its assets for their fair market value, all gain would be long-term.
b. The result in Example 1 can be avoided by lending to the partnership, instead of making a capital contribution to the partnership.

c. Example 2. In Year 1, Partners A and B form Partnership by making equal contributions of property with a basis of $90 and a fair market value of $90. The contributed property depreciates in value, so that, by Year 2, the value of each Partnership interest is only $10. In Year 2, A and B each make an additional contribution of $20 to the capital of Partnership. As a result of the contribution, A and B have a new holding period in two thirds of each Partner’s interest. If either of the Partners sells his Partnership interest in Year 2, one third of the loss will be long-term capital loss, but two thirds of the loss will be short-term capital loss. This result again seems inappropriate but it can be advantageous to the selling partners.

d. A partner would be required to recognize gain on a distribution only if money distributed exceeds the partner’s basis in its partnership interest. Section 731(a)(1).

e. A partner would be required to recognize loss only if in a liquidating distribution the partner receives only money, unrealized receivables and inventory and its basis exceeds the amount of money and unrealized receivables and inventory distributed. Section 731(a)(2).

Q. Using Leases to Extend Holding Periods

1. Lease With an Option to Purchase

a. A holding period may be extended by leasing the property and granting the lessee an option to purchase that may be exercised only after the desired holding period is achieved. However, care must be taken to avoid recharacterization of the lease as a sale. See Rev. Rul. 55-540, 1955-2 C.B. 39; Bowen v. Commissioner, 12 T.C. 446 (1949) (lease purporting to transfer title to the tenant when the lease payments equaled the value of the property plus one percent was a sale).

b. In determining whether a transaction qualifies as a true lease, the Service takes the substance-over-form approach. Rev. Rul. 68-590, 1968-2 C.B. 66. The following factors are relevant:

(i) the overall economic reality of the transaction;
(ii) the relationship between the rent under the lease and the fair market value of the property;

(iii) the presence or absence of an option to purchase the property with some or all of the lease payments, especially if the payment of the stated rent is required;

(iv) express or implied designation of a part of the lease payment as an equity interest for the lessee;

(v) express or implied allocation of a portion of the lease payments to interest;

(vi) tenant improvements.

c. The mere presence of the option to purchase is not enough to establish taxable sale. Smith v. Commissioner, 51 T.C. 429 (1968).

d. In the case of an option to purchase, recharacterization is likely if:

(i) the option price is nominal in relation to the value of the property at the time of exercise. See, e.g., Frito-Lay, Inc. v. Commissioner, 209 F.Supp. 886 (D.C. Ga. 1962) (option price $50,000 on a property worth $1.6 million).


(iii) the lease payments coupled with the purchase option equal the fair market of the property. See, e.g., M & W Gear Co. v. Commissioner, 446 F.2d 841 (7th Cir. 1971) (the lease payments which were more than double the property’s current fair rental value, coupled with the option price, equaled the property’s fair market value).

e. Recharacterization is not likely if:

(i) The option price set at the inception of the lease does not make the exercise of the option economically inevitable. See, e.g., Northwest Acceptance Corp. v. Commissioner, 500 F.2d 1222 (9th Cir. 1974).
(a) Rev. Proc. 75-21, 1975-1 C.B. 715, sets forth the Service's advance ruling criteria and provides that, when the property is first placed in service or use by the lessee, the lessor may not have a contractual right to cause any party to purchase the property.

(b) The effect of such right acquired after the property is first placed in service or use by the lessee is determined at that time based on all the facts and circumstances. Id.

(ii) The lessee does not receive equity in the leased property. Northwest Acceptance Corp., supra.

(a) Rev. Proc. 75-21 provides that the lessee should not guarantee any of the lessor's debt in connection with the property, and should not lend money to the lessor.

(iii) The risk in the residual value of the property remains in the lessor. Northwest Acceptance Corp., supra. Rev. Proc. 75-21 identifies the following safe harbors:

(a) The lessor should have an at-risk investment in the lease of at least 20% of the cost of the property at the time of inception.

(b) The residual value of the property at the end of the lease should be at least 20% of the original cost of the property.

(c) The remaining useful life of the property at the end of the lease should be at least 20% of the property's originally estimated useful life, or at least one year.

f. If the transaction is recharacterized, all payments made under the lease are considered installment payments of the purchase price rather than rents. Depending on the dealer status of the taxpayer, installment method may or may not be available. Section 453(b); Rev. Rul. 67-188, 1967-1 C.B. 216 (real property owned by a limited partnership was section 1231 property for purposes of determining gain or loss, even though the partnership's general partner was a dealer).
(i) if the lease involves an option to purchase, the present value of the option price is immediately included in the computation of the lessor’s gain.

(ii) alternatively, the option price may be treated as a nonquotable contingent payment under Treas. Reg. § 1.1275-4(c)(4). Because such contingent payments are not taken into account until paid, the initial gain to the lessor would be reduced.