Property and Liability Transfers to Partnerships: Built-In Gain or Loss, Boot, and Disguised Sales

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PARTNERSHIPS: BUILT-IN GAIN OR LOSS, BOOT AND
DISGUISED SALES

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November 16, 2006
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I. CONTRIBUTION OF CASH OR PROPERTY - TREATMENT UNDER CODE SEC.
721(A)

A. In general, the transfer of property to a partnership in exchange for a partnership interest will not result in the recognition of gain or loss. Code Sec. 721(a).

B. The partner who contributed property to a partnership in exchange for a partnership interest will take an initial basis in the partnership equal to the amount of any money contributed and the adjusted basis of the contributed property. Code Sec. 722.

II. CERTAIN EXCEPTIONS TO NONRECOGNITION TREATMENT

A. Assumption of liabilities by the partnership

1. Contribution of encumbered property to a partnership can result in gain recognition under Code Sec. 731(a)(1) if there is a distribution of money, actual or deemed, to the Contributing Partner which exceeds its basis in the Partnership. Code Sec. 731(a)(1) provides that gain is recognized to the extent that any money distributed exceeds the adjusted basis of the partner’s interest in the partnership immediately before the distribution. In analyzing whether a distribution by a partnership to a partner exceeds the partner’s basis in its partnership interest, the amount of any “deemed distribution” of money under Code Sec. 752(b) must be considered.

2. Under Code Sec. 752 any increase in a partner’s share of the liabilities of a partnership, or any increase in a partner’s individual liabilities by reason of the assumption by such partner of partnership liabilities, is treated as a contribution by such partner to the partnership and any decrease in a partner’s share of the liabilities of a partnership, or any decrease in a partner’s individual liabilities by reason of the assumption by the partnership of such individual liabilities, is treated as a distribution of money to the partner by the partnership. If there is a net decrease in the partner’s share of liabilities, this decrease is treated as a deemed distribution from the partnership for purposes of Code Sec. 731(a).

3. Property is frequently contributed to a partnership is subject to liabilities in excess of the properties adjusted tax basis. In order to avoid gain recognition on the contribution, it is necessary to determine whether the amount of any deemed distribution exceeds the Contributing Partner’s
basis in the partnership. Thus, it is necessary to determine the
Contributing Partner's share of both recourse and nonrecourse liabilities of
the partnership.

4. Determining a Contributing Partner's share of recourse liabilities

a. A partner's share of a recourse partnership liability equals the
portion of that liability, if any, for which the partner or related
person bears the economic risk of loss. Treas. Reg. § 1.752-1(a).

b. A partner bears the economic risk of loss for a liability to the
extent that if the partnership constructively liquidated, the partner
would be obligated to either pay a creditor or make a contribution
to the partnership because the liability would be due and the
partner would not be entitled to reimbursement. Treas. Reg. §
1.752-2(b).

c. Determining a Contributing Partner's share of nonrecourse liabilities.

(i) A partner's share of partnership nonrecourse liabilities equals the
sum of the following:

(a) a partner's share of partnership minimum gain determined
pursuant to Code Sec. 704(b); Treas. Reg. § 1.752-3(a)(1)
(minimum gain is generally the excess of the nonrecourse
liability over the Code Sec. 704(b) book value of property
securing the liability) [the "First Tier"];

(b) the amount of any taxable gain that would be allocated to
the partner under Code Sec. 704(c) (or in the same manner
as under Code Sec. 704(c) if partnership property is
revalued) if the partnership disposed of all partnership
property subject to nonrecourse liabilities for no
consideration other than full satisfaction of the liabilities;
therefore, the partner's share of nonrecourse liabilities will
take into account any built-in gain in the contributed or
revalued property; Treas. Reg. § 1.752-3(a)(2) [the
"Second Tier"];

(c) the partner's share of the excess nonrecourse liabilities
determined in accordance with the partner's share of
partnership profits. Alternatively, the partnership may first
allocate excess nonrecourse liabilities to a partner up to the
amount of built-in gain that is allocable to the partner on
Code Sec. 704(c) property or property for which reverse
Code Sec. 704(c) allocations are applicable by virtue of a
book-up (as described in Treas. Reg. §1.704-3(a)(6)(i))
where such property is subject to the nonrecourse liability

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to the extent that such built-in gain exceeds the gain allocated under the Second Tier with respect to such property. If the allocation is made using this alternative mechanism, any remaining excess nonrecourse liabilities must then be allocated in accordance with the partner’s share of partnership profits. Treas. Reg. § 1.752-3(a)(3) [the “Third Tier”].

(ii) Where the contributed property is depreciable, the amount of Code Sec. 704(c) minimum gain is reduced over time as book and tax depreciation deductions are claimed. When the property is fully depreciated, Code Sec. 704(c) minimum gain will be reduced to zero.

(iii) Rev. Rul. 95-41, 1995-1 C.B. 132, explains how Code Sec. 704(c) affects allocations of nonrecourse liabilities under Treas. Reg. § 1.752-3(a).

(a) Allocations under the First Tier of Treas. Reg. § 1.752-3(a)(1) are not affected by Code Sec. 704(c).

(b) Allocations under the Second Tier of Treas. Reg. § 1.752-3(a)(2):

(I) take into account remedial allocations of gain that would be made to the Contributing Partner under Treas. Reg. § 1.704-3(d),

(II) do not take into account curative allocations under Treas. Reg. § 1.704-3(c).

(c) Allocations under the Third Tier of Treas. Reg. § 1.752-3(a)(3) are affected by Code Sec. 704(c) in the following manner:

(I) If the partnership determines the partners’ interests in partnership profits based on all of the facts and circumstances relating to the economic arrangement of the partners, Code Sec. 704(c) built-in gain that was not taken into account under Treas. Reg. § 1.752-3(a)(2) is one factor, but not the only factor, to be considered under Treas. Reg. § 1.752-3(a)(3).

(II) If the partnership chooses to allocate excess nonrecourse liabilities in a manner reasonably consistent with allocations (that have substantial economic effect under the Code Sec. 704(b) regulations) of some other significant item of
partnership income or gain, Code Sec. 704(c) does not affect the allocation of nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3) because Code Sec. 704(c) allocations do not have substantial economic effect.

(III) If the partnership chooses to allocate excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that deductions attributable to the nonrecourse debt will be allocated, the partnership must take into account the Code Sec. 704(c) allocations in determining the manner in which the deductions attributable to the nonrecourse liabilities will be allocated.

(d) The importance of the holding of Rev. Rul. 95-41 regarding the impact of Code Sec. 704(c) in determining the Third Tier allocation has been eclipsed by the rule in Treas. Reg. § 1.752-3(a)(3) allowing the Third Tier to be allocated first to a partner up to the amount of built-in gain allocable to such partner not taken into account in the Second Tier, which was added by an amendment to Treas. Reg. § 1.752-3(a)(3) issued October 30, 2000.

(iv) For purposes of determining the amount of partnership liabilities that are allocable to a partner under the Second Tier, where there are multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties using any reasonable method. Treas. Reg. § 1.752-3(b)(1).

(v) The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan. In general, a partnership may not change the method of allocating a single nonrecourse liability while any portion of the liability is outstanding. However, when any such property ceases to be subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability. Treas. Reg. § 1.752-3(b)(1).

(vi) The method for allocation of the liability is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred. Treas. Reg. § 1.752-3(b)(1).

(vii) In situations where partners in a partnership contribute their partnership interests in the partnership to the partnership, thus
creating a tiered partnership ownership structure, complexities arise in the sharing of liabilities and the application of Code Sec. 704(c). For a comprehensive discussion of these issues, see Blake D. Rubin and Andrea R. Macintosh, Exploring the Outer Limits of the 704(c) Partnership Built-In Gain Rule, J. Tax'n Vol. 89, Nos. 3, 4 and 5 (Sept., Oct., Nov. 1998).

B. Contributions subject to Code Sec. 721(b)

1. Code Sec. 721(b) provides that gain may be realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of Code Sec. 351) if the partnership were incorporated.

2. If the partnership were incorporated it would not be treated as an investment company under Code Sec. 351 if 80 percent of its assets are not "stocks and securities" as defined in Code Sec. 351(e)(1).

III. CODE SEC. 704(C) BUILT-IN GAIN

A. When property is contributed to the partnership, any inherent built-in gain or built-in loss in the property must be taken into account.

B. Allocation Methods - Built-In Gain or Loss on Property Contribution

1. Code Sec. 704(c) generally requires that any built-in gain or loss (i.e., difference between value and basis) inherent in property at the time of its contribution to a partnership or at the time of its revaluation must be allocated to the Contributing Partner (or partners whose capital accounts are increased in the revaluation) when the built-in gain or loss is recognized.

2. Moreover, the allocation of cost recovery deductions must take into account built-in gain or loss on the property. In general, the rules require that the noncontributing Partner be put in the same position it would have been in had the property had basis equal to value. Put differently, to the extent possible, the noncontributing partner must be allocated cost recovery deductions for tax purposes equal to its book allocation of cost recovery deductions.

3. The amount of built-in gain or loss that must be allocated to a partner under Code Sec. 704(c) at any point in time is equal to the difference between its "book" basis and its tax basis. Treas. Reg. § 1.704-3(b)(3)(ii).

C. Three principal methods of making Code Sec. 704(c) allocations
1. There is an inherent conflict between the interests of the partnership and the Contributing Partner in the selection of a Code Sec. 704(c) allocation method.

2. The allocation method most favored by the Contributing Partner would defer the recognition of its built-in gain as long as possible, subject to its need to retain a sufficient share of liabilities (see discussion of Code Sec. 752 below).

3. The allocation method most favored by the partnership may result in acceleration of the Contributing Partners’ recognition of their built-in gain.

D. The Traditional Method

1. Treas. Reg. § 1.704-3(b) sets forth the traditional method of making Code Sec. 704(c) allocations. Under the traditional method, the “ceiling rule” applies.

2. The ceiling rule prevents the partnership from allocating tax cost recovery deductions to partners that exceed the total cost recovery deductions attributable to that property. Treas. Reg. § 1.704-3(b)(1). As a result of the ceiling rule, a noncontributing partner may not be able to receive tax depreciation deductions on the contributed or revalued property equal to the deductions it would have received if the property had basis equal to value.

E. The Traditional Method with Curative Allocations

1. Treas. Reg. § 1.704-3(c) sets forth the rules governing application of the traditional method with curative allocations. This method is designed to correct distortions that are created by application of the ceiling rule in the traditional method.

2. Under the traditional method with curative allocations, the partnership is permitted to reduce or eliminate book/tax disparities of the noncontributing partners by making “curative” allocations of other items of income, gain, loss or deduction.

3. When a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of Code Sec. 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference, notwithstanding that the corresponding book depreciation is being allocated to the Contributing Partner. Moreover, a partnership may limit its curative allocations to allocations of one or more particular tax items (e.g., only depreciation from specific property) in spite of the fact that these allocations do not offset fully the effect of the ceiling rule. Curative allocations do not affect the partners’ book capital accounts.
F. The Remedial Allocation Method

1. Treas. Reg. § 1.704-3(d) sets forth the rules governing the remedial allocation method of making Code Sec. 704(c) allocations. This method is designed to eliminate any book/tax disparity in allocations of partnership items regardless of the availability of partnership items to allocate.

2. The remedial allocation method eliminates the disparity through “creating” and allocating remedial items. Unlike curative allocations, the remedial allocations are not limited by actual items of income, gain, loss or deduction in the partnership.

3. In calculating the amount of the book items attributable to the contributed property, the partnership’s book basis (to the extent of adjusted tax basis) is recovered in the same manner as the adjusted tax basis, over the property’s remaining recovery period, with the excess book basis being recovered using the depreciation method otherwise used by the partnership for newly acquired property that is placed in service on the date of contribution.

4. Remedial allocations have the same tax attributes as the tax item to which they apply, limited by the ceiling rule. Therefore, if the ceiling rule limited item is depreciation from property used in a rental activity, the remedial allocation to the noncontributing partner is depreciation from property used in a rental activity and the offsetting remedial allocation to the contributing partner is ordinary income from that rental activity.

5. Remedial allocations do not affect the partners’ book capital accounts. Remedial allocations affect a partner’s adjusted tax basis in the partnership interest in the same manner as do actual tax items.

IV. CODE SEC. 704(C)(1)(C) - BUILT-IN LOSSES

A. In General.

1. The interaction of Code Sec. 721 and Code Sec. 704(c)(1)(A) led to the possibility that built-in losses could be “duplicated” and transferred in a transaction along the lines described in the following example.

2. Example. A contributes Property 1 with a basis of $10,000 and a fair market value of $5,000 to Partnership AB. B contributes $5,000 cash to Partnership AB. As a result of the contribution of Property 1, under Code Sec. 722, A takes an adjusted basis in its interest in Partnership AB equal to its adjusted basis in Property 1, or $10,000. In addition, under Code Sec. 723, Partnership AB takes a basis in Property 1 equal to A’s basis in Property 1, or $10,000. Thereafter, A sells its interest in Partnership AB to C for $5,000 and A recognizes a $5,000 loss. If Partnership AB does not have a Code Sec. 754 election in effect, there would be no downward
adjustment to the basis of AB’s assets under Code Sec. 743(b) on account of the sale of A’s interest to C. If Partnership AB subsequently sells Property 1 for $5,000, Partnership AB will recognize an additional $5,000 loss, which under Treas. Reg. § 1.704-3(a)(7) must be allocated to C as A’s transferee.\(^1\) If Code Sec. 704(c)(1)(C) is applied to Example, after A’s sale of its partnership interest to C, Partnership AB’s basis in Property 1 would presumably be reduced to $5,000. As a result, Partnership AB would recognize no gain or loss on a subsequent sale of Property 1 for $5,000 and no loss is shifted or duplicated.

B. Jobs Act\(^2\)

1. Code Sec. 704(c)(1)(C), as added by the Jobs Act, provides that if property contributed to a partnership has a built-in loss, such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner. Code Sec. 704(c)(1)(C)(i).

2. The basis of the contributed property in the hands of the partnership is treated as equal to the fair market value of the property at the time of contribution for purposes of determining the amounts of items allocated to noncontributing partners. The Service has authority to clarify this rule in regulations. Code Sec. 704(c)(1)(C)(ii).

3. “Built-in loss” is defined as any excess of adjusted basis over fair market value at the time of contribution. The restriction on allocating built-in loss to noncontributing partners is not subject to any minimum dollar safe harbor.

4. Effective Date. This provision is effective for contributions made after October 22, 2004.

5. Code Sec. 704(c)(1)(C) does not apply to “reverse” Code Sec. 704(c) built-in losses that arise on a book-down of a partnership’s assets\(^3\) or if, instead of a book-down, a partnership agreement provides for a special allocation of built-in loss to historic partners under Code Sec. 704(b), as suggested by Treas. Reg. § 1.704-1(b)(5), Example 14(iv). In a related context, the Service recently conceded that the partnership “anti-mixing

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\(^1\) The Service could attack the transaction in this Example under the “partnership anti-abuse rule” contained in Treas. Reg. § 1.701-2, if the “partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners’ aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K.” See Treas. Reg. § 1-701-2(d) Example 8.

\(^2\) American Jobs Creation Act of 2004, signed into law by the President on October 22, 2004

bowl rule" of Code Sec. 704(c)(1)(B) does not apply to "reverse" Code Sec. 704(c) allocations occasioned by a book-up.

V. PROTECTING AGAINST FUTURE GAIN

A. When a partner contributes Code Sec. 704(c) built-in gain property to a partnership (hereinafter the "Contributing Partner"), the Contributing Partner wants assurances that the partnership refrain from taking any action that may trigger that gain prematurely.

B. Unless the partnership agreement provides otherwise, the partnership may be entitled sell or otherwise dispose of one or more of its real estate assets or refinance its existing debt facilities.

1. Contributing Partners should negotiate for some control over transactions that will jeopardize the coveted tax deferral achieved on the property contribution. Generally, the partnership is prohibited from undertaking certain acts for a certain time period, without first obtaining the written consent of the Contributing Partner. If the partnership does engage in the prohibited act during the specified period, it typically will be required to make a "tax indemnification" or "make-whole" payment to the Contributing Partner.

2. The partnership and Contributing Partners have conflicting interests as it relates to tax deferral protection. Accordingly, extensive negotiations are typical in an effort to protect the Contributing Partner's tax deferral while enabling the partnership to retain flexibility in managing its real estate assets. For liquidity reasons, the partnership generally disfavors strict lockout terms and lengthy lockout periods that limit its ability to manage its real estate assets.

C. It is common to negotiate a lock-out period of five to fifteen years. In rare cases, partnerships have agreed to lock-out periods that expire upon the death of the Contributing Partner.

D. The Code Sec. 704(c) method utilized by the partnership with respect to the property contributed by the Contributing Partner also impacts the lock-out period negotiation.

E. The lock-up negotiation will typically focus on activities that would accelerate the recognition of gain.

F. A taxable disposition of the property contributed by the Contributing Partners will trigger all or a portion of such partners deferred built-in gain under Code Sec. 704(c). Contributing Partner should negotiate to substantially restrict or eliminate the partnership's ability to sell the contributed property without obtaining their consent.

1. To the extent that the Contributing Partner is relying on an allocation of debt from the partnership in order to avoid immediate gain recognition, the Contributing Partner will negotiate for restrictions on refinancing of the debt of the partnership in a manner that triggers the Contributing Partner's gain. Generally, the partnership will seek to refinance the debt on contributed property with its own lender on favorable terms. The agreement not to refinance or reduce the debt level may raise significant issues with lenders.

2. The lock-up negotiation may also include certain affirmative undertakings by the partnership to avoid the acceleration of the recognition of gain after expiration of the lock-up period.

   a. During the term of the lock-out period, Contributing Partners will generally permit the partnership to dispose of the contributed property through a tax-deferred like-kind exchange. Contributing Partners should negotiate for an undertaking by the partnership that to the extent that the partnership desires to dispose of the contributed property after expiration of the lock-out period, the partnership will use its reasonable best efforts to accomplish such disposition through a tax-deferred like-kind exchange.

   b. The Contributing Partner will frequently press for a commitment that during the term of the lock-out period, the partnership must use its reasonable best efforts to acquire replacement property in the event of an involuntary conversion within the meaning of Code Sec. 1033.

   c. The Contributing Partner may negotiate to require the partnership to first offer the contributed property back to the Contributing Partner in the event that after the expiration of the lock-out period the partnership desires to sell the contributed property. The right would be structured such that the Contributing Partner would be redeemed out of the partnership in exchange for the property it
previously contributed. By exercising this right and being redeemed out of the partnership, the Contributing Partner may be able to avoid the recognition of the built-in gain under Code Sec. 704(c) that would have otherwise been recognized on a taxable sale of the contributed property by the partnership to a third party. See Code Sec. 731.

d. The partnership will negotiate to exclude involuntary events from the list of acts that trigger the “tax indemnification” or “make-whole” payment. Although the partnership may agree to avoid certain affirmative acts that are within its sole control, the partnership is reluctant to be burdened by a tax indemnification running to the Contributing Partner for acts that are not within the partnership’s control. Significantly, the partnership will seek to exclude from the list of prohibited acts the following: The failure to take certain affirmative acts, such as (A) the failure to make a loan to the partnership; or (B) the failure to make an additional capital contribution to the partnership. Involuntary acts such as a transfer of the property by (A) condemnation, (B) under threat of condemnation, (C) by foreclosure or a similar proceeding or (D) by deed in lieu of foreclosure.

3. Typically, the Contributing Partner will allow the partnership to engage in a prohibited act during the lock-out period provided that the partnership makes the Contributing Partner “whole” by a payment of cash. The formula for the tax indemnification may provide for any of the following: the payment to the partner of the time value of money cost of accelerating the recognition of tax from the expiration of the lock-out period; the payment to the partner of the entire tax liability; or the payment to the Contributing Partner of the aforementioned amounts, as well as a gross-up amount to take into account the additional tax liability incurred on the tax indemnification payment itself. The tax indemnification may provide for the payment of both Federal and State tax liabilities.

a. The tax indemnification will often assume a maximum tax rate. The partnership will negotiate for a tax indemnification calculated at capital gains rates and the Contributing Partner will negotiate for a tax indemnification calculated at the highest marginal applicable tax rate with respect to such income or gain (taking into account the amount and character of the income or gain).

b. In addition, the Contributing Partner will negotiate for a determination of the tax indemnification amount without regard to any net losses, loss carry forward, deferred deductions or similar items that would reduce the effective rate of tax applicable to the Contributing Partner.
VI. IMPACT OF PROPERTY CONTRIBUTION ON OTHER PARTNERS

A. In General.

1. The capital account maintenance rules provide that the capital account of a partner must be increased by the fair market value of property contributed to the partnership by the partner.

2. These rules also includes a mechanism whereby the capital accounts of the noncontributing partners in the partnership are increased ("book-up") or decreased ("book-down") to reflect a revaluation of partnership property on the partnership's books on the occurrence of certain events. Treas. Reg. § 1.704-1(b)(2)(iv)(f).

B. Book-up of Capital Accounts and Allocation Issues Attributable to Revalued Property

1. Code Sec. 704(b) provides that the allocation of the items of income, gain, loss, deduction or credit must have substantial economic effect or the amounts will be reallocated in accordance with the partners' interests in the partnership.

2. The regulations under Code Sec. 704(b) contain a "safe harbor" that includes capital account maintenance rules that require positive capital account adjustments reflecting "partnership income and gain (or items thereof)" and negative capital account adjustments reflecting "partnership loss or deduction (or items thereof)." Under the safe harbor, allocations will be respected if they have "substantial economic effect."

3. The substantial economic effect test will be satisfied if: (1) a partnership allocation has economic effect; and (2) the economic effect is substantial. Treas. Reg. § 1.704-1(b)(2).

4. Generally, an allocation will have economic effect only if the partnership agreement provides that:

   a. the partners' capital accounts are determined and maintained in accordance with the capital accounting rules provided in the regulations;

   b. liquidation proceeds are to be distributed in accordance with the partners' positive capital account balances; and

   c. a partner is unconditionally obligated, following liquidation of his partnership interest, to restore any deficit balance in his capital account to the partnership by the end of the tax year, or, if later, within 90 days after the date of liquidation. Treas. Reg. § 1.704-1(b)(2).
d. Alternatively, under certain circumstances, partnership allocations may have economic effect even though the third requirement is not met if the partnership agreement contains a "qualified income offset" provision. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

5. Special rules apply with respect to the allocation of "nonrecourse deductions" and "partner nonrecourse deductions". See Treas. Reg. § 1.704-2.

6. Treas. Reg. § 1.704-1(b)(2)(iv)(f) provides a mechanism by which the capital accounts of partners can be increased or decreased to reflect a revaluation of partnership property on the partnership's books. Where partnership property is subject to nonrecourse debt, any such revaluation of encumbered property is based on the greater of the fair market value of the property or the amount of the nonrecourse debt outstanding immediately following the exchange.

a. After a revaluation, tax items arising from the property must be shared among the partners in a manner similar to Code Sec. 704(c). Treas. Reg. § 1.704-1(b)(4)(i).

b. Pursuant to these regulations, the partnership may restate the existing partners' capital accounts upon the entry of a new partner, by revaluing the partnership's property to its fair market value. Such revaluation reflects unrealized gain, loss, income or deduction inherent in the property that would be allocated to the existing partners if the property were disposed of in a taxable transaction in exchange for an amount equal to its fair market value as of the date of the new partner's capital contribution. This restatement of capital accounts ensures that the new partners will not share in pre-contribution appreciation or depreciation in value of the partnership's assets.

VII. DISGUISED SALES

A. In General.

1. Code Sec. 707(a)(2)(B) provides that, under regulations prescribed by the Secretary, transfers to and by a partnership that are more properly characterized as transactions between the partnership and one who is not a partner or between two or more partners acting other than in their capacity as partners shall be treated as such transactions.

2. On September 30, 1992, final regulations were issued relating to disguised sales of property to and by partnerships. However, Treas. Reg. § 1.707-7 was reserved for rules relating to disguised sales of partnership interests.

B. Historical Perspective
1. Prior to 1984

a. Prior to the enactment of Code Sec. 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. This was the case because, generally, contributions of property to and distributions of property from a partnership are not taxable to the partnership or its partners.\(^5\)

b. Longstanding regulations under Code Secs. 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.\(^6\)

c. 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.

d. For example, in *Otey v. Commissioner*,\(^7\) a taxpayer formed a partnership with another party in order to construct FHA-financed housing on property owned by the taxpayer. The taxpayer contributed the property to the partnership with an agreed value of $65,000, while the other party contributed no capital. The partnership obtained a construction loan and the taxpayer received a distribution from the partnership of the first $65,000 of proceeds from the construction loan within six months after the formation of the partnership and the transfer of the property to it. The court held that the taxpayer’s contribution of property to the partnership and the partnership’s distribution of cash to the taxpayer were tax-free under Code Secs. 721(a) and 731(a), and did not constitute a taxable sale by the contributing partner to the partnership under Code Sec. 707(a).

2. Enactment of Code Sec. 707(a)(2)(B)

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\(^5\) Code Secs. 721 and 731.

\(^6\) Reg. §§1.731-1(c)(3), 1.721-1(a).

\(^7\) 70 T.C. 312 (1978), *aff’d per curiam*, 80-2 U.S.T.C. ¶9817 (6th Cir. 1980).
a. Congress expressed its disapproval of Otey and similar cases by enacting Code Sec. 707(a)(2)(B) as part of the Deficit Reduction Act of 1984.8

b. Code Sec. 707(a)(2)(B), which was generally effective for property transferred after March 31, 1984,9 recharacterizes transactions involving the contribution of property to a partnership and the distribution of property from a partnership as one of two types of sale or exchange transactions. The first is the sale or exchange of property between a partner and a partnership. The second is the sale or exchange of a partnership interest by one partner to another partner.

C. Disguised Sales of Property

1. In General.

a. Whenever there is a contribution of property to a partnership, it is necessary to analyze the transaction in light of the disguised sale rules set forth in Code Sec. 707 in order to ensure that the transaction will not be recast as a taxable sale. For a comprehensive discussion of these issues, see Blake D. Rubin, Andrea R. Macintosh, and Lark Mallory, Working with the Partnership Disguised Sale and Anti-Mixing Bowl Rules., 58th N.Y.U. Tax Inst. Ch. 10 (2000).

b. It is critical that the terms associated with the partnership interest that is acquired are analyzed to ensure that they do not trigger application of the disguised sale rules.

c. Code Sec. 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 non-partner capacity.

d. Code Sec. 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

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9 Id.
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.

2. Identifying Disguised Sales

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).

   (ii) 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).

b. 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).

c. Two-Year Presumption

(i) 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).

(ii) This presumption is rebuttable only if “the facts and circumstances clearly establish that the transfers do not constitute a sale.” Id.
(iii) 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).

(iv) 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.

(v) 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."

(vi) 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.

d. Guaranteed Payments

(i) 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).

(ii) 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. Code Sec. 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).
(iii) 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).

(iv) 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).

(v) 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.

(vi) 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.

(vii) 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).

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

(ix) 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).

(x) 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.

e. Preferred Returns

(i) 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).

(ii) 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.

(iii) The regulations do not contain an example involving a preferred return.

f. Cash Flow Distributions

(i) 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).

(ii) 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).

(iii) 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).

(iv) 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).

(v) 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).

g. Preformation Expenditures

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

(ii) 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 Code Sec. 709 or for property contributed to the partnership by the partner.  Id.

(iii) 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.

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

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

3. Treatment of Liabilities

   a. Encumbered Property

      (i) 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.

      (ii) The portion of the liability treated as shifted to other partners depends on whether the liability is recourse or nonrecourse.

      (iii) A special set of more favorable rules applies with respect to "qualified liabilities."
b. Sharing of Liabilities

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

(ii) 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).

c. Qualified Liabilities

(i) The regulations define four categories of liabilities that are "qualified liabilities" as follows:

(a) 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).

(b) 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).

(I) 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).

(II) 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).

(III) 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).

(c) A liability that is allocable under the interest tracing rules of Treas. Reg. § 1.163-8T to capital expenditures with respect to the transferred property. Treas. Reg. § 1.707-5(a)(6)(i)(C).

(d) 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).

d. 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)(i)(ii).

e. 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).

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

(i) 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

(ii) 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).

h. Debt-Financed Distributions

(i) 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).

(ii) 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).

(iii) 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).
D. Disguised Sales of Partnership Interests

1. Proposed Code Sec. 707 Regulations.

   a. On November 26, 2004, proposed regulations were issued regarding disguised sales of partnership interests. The proposed regulations generally follow the existing regulations related to disguised sales of property with some modifications.

   b. The proposed regulations provide that a transfer of money, property or other consideration (including the assumption of a liability) ("consideration") by a partner (the "purchasing partner") to a partnership and transfer of consideration by the partnership to another partner (the "selling partner") constitutes a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner only if, based on all the facts and circumstances, the transfer by the partnership would not have been made but for the transfer to the partnership, and, in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. Prop. Treas. Reg. § 1.707-7(b)(1).

   c. Facts and Circumstances. Among the facts and circumstances that may prove the existence of a disguised sale of a partnership interest as described above are:

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

      (ii) That the person receiving the subsequent transfer has a legally enforceable right to the transfer or that the right to receive the transfer is secured in any manner, taking into account the period for which it is secured;

      (iii) That the same property (other than money, including marketable securities that are treated as money under Code Sec. 731(c)(1) ("Money Equivalents")) that are transferred to the partnership by the purchasing partner are transferred to the selling partner;

      (iv) That partnership distributions, allocations or control of operations are designed to effect an exchange of the benefits and burdens of ownership of transferred property (other than money or Money Equivalents), including a partnership interest;
(v) That the partnership holds transferred property (other than money or Money Equivalents) for a limited period of time, or during the period of time the partnership holds transferred property (other than money or Money Equivalents), the risk of gain or loss associated with the property is not significant;

(vi) That the transfer of consideration by the partnership to the selling partner is disproportionately large in relationship to the selling partner’s general and continuing interest in partnership profits;

(vii) That the selling partner has no obligation to return or repay the consideration to the partnership, or has an obligation to return or repay the consideration due at such a distant point in the future that the present value of that obligation is small in relation to the amount of consideration transferred by the partnership to the selling partner;

(viii) That the transfer of consideration by the purchasing partner or the transfer of consideration to the selling partner is not made pro rata;

(ix) That there were negotiations between the purchasing partner and the selling partner (or between the partnership and each of the purchasing and selling partners with each partner being aware of the negotiations with the other partner) concerning any transfer of consideration; and

(x) That the selling partner and purchasing partner enter into one or more agreements, including an amendment to the partnership agreement (other than for admitting the purchasing partner) relating to the transfers. Prop. Treas. Reg. § 1.707-7(b)(2).

d. Certain Transfers Disregarded. The proposed regulations provide that Code Sec. 707(a)(2)(B) and the proposed regulations do not apply to deemed transfers resulting from a termination of a partnership under Code Sec. 708(b)(1)(B) and transfers incident to the formation of a partnership. Prop. Treas. Reg. § 1.707-7(a)(8).

2. Treatment of Transfers as a Sale.

a. If a transfer of consideration by a purchasing partner to the partnership and a transfer by the partnership to the selling partner are treated as part of a sale of a partnership interest, the proposed regulations provide that the transaction is treated as a sale for all purposes of the Code. Prop. Treas. Reg. § 1.707-7(a)(2)(ii)(E).
b. The sale is considered to take place on the date the earliest transfer takes place. Prop. Treas. Reg. § 1.707-7(a)(2)(ii).

c. If the transfer by the partnership occurs before the transfer to the partnership, the partners and the partnership are treated as if, on the date of the sale, the purchasing partner transferred to the partnership an obligation to deliver that partner's consideration in exchange for the consideration transferred by the partnership to the selling partner, and the purchasing partner transferred the selling partner's consideration to the selling partner in exchange for the selling partner's partnership interest.

d. If the transfer by the partnership occurs after the transfer to the partnership, the partners and the partnership are treated as if, on the date of the sale, the purchasing partner transferred that partner's consideration to the partnership in exchange for an obligation of the partnership to deliver the selling partner's consideration, and the purchasing partner transferred that obligation to the selling partner in exchange for the selling partner's partnership interest.

3. Presumptions.

a. Transfer Made Within Two Years. The proposed regulations provide that a transfer of consideration by a purchasing partner to a partnership and a transfer of consideration by the partnership to the selling partner that are made within two years of each other are presumed to be a sale, and that such transfers made more than two years apart are presumed not to be a sale. Prop. Treas. Reg. § 1.707-7(c) and (d).

b. Complete Liquidations of a Partner's Interest. The proposed regulations provide that, notwithstanding the presumption relating to transfers made within two years, a transfer of money or Money Equivalents to a selling partner in liquidation of that partner's entire interest in the partnership is presumed not to be part of a disguised sale of that interest. Prop. Treas. Reg. § 1.707-7(e).

c. Service Partnership Exception. The proposed regulations provide that transfers of money or Money Equivalents to and by a partnership that would be described in Code Sec. 448(d)(2) if the partnership were a corporation are not sales of partnership interests. Prop. Treas. Reg. § 1.707-7(g).

4. Liabilities.

a. Reallocations of Partnership Liabilities. The proposed regulations generally provide that deemed contributions to and distributions from a partnership under Code Sec. 752 resulting from
reallocations of partnership liabilities among partners are not treated as transfers of consideration for purposes of the disguised sale rules. However, as discussed below, the amount realized by a selling partner on the sale of the selling partner's interest in the partnership includes any liability relief that occurs in connection with the sale. Prop. Treas. Reg. § 1.707-7(j)(1).

b. Partner Liability Assumed by Partnership or Partnership Liability Assumed by Partner.

(i) The proposed regulations provide that, if a partnership assumes a liability of a partner, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of the liability immediately after the partnership assumes the liability. Prop. Treas. Reg. § 1.707-7(j)(2).

(ii) Similarly, if a partner assumes a liability of a partnership, the partner is treated as transferring consideration to the partnership to the extent that the amount of the liability exceeds the partner's share of that liability immediately before the partner assumes the liability. Prop. Treas. Reg. § 1.707-7(j)(3).

(iii) A partner's share of any liability of the partnership for these purposes is determined as follows:

(a) Recourse Liabilities. A partner's share of a recourse liability of the partnership equals the partner's share of the liability under Code Sec. 752 and the regulations thereunder. Prop. Treas. Reg. § 1.707-7(j)(4)(i).

(b) Nonrecourse Liabilities. A partner's share of a nonrecourse liability of the partnership is generally 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). Prop. Treas. Reg. § 1.707-7(j)(4)(ii).

c. Debt Financed Transfers of Consideration by Partnerships. The proposed regulations provide that, if a partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under Treas. Reg. § 1.163-8T to a transfer of consideration to a partner made within 90 days of incurring the liability, the transfer of consideration to the partner is taken into account only to the extent that the amount of consideration transferred exceeds that

d. Anti-abuse Rule. The proposed regulations provide that an increase in a partner's share of a partnership liability may be treated as a transfer of consideration by the partner to the partnership if:

(i) within a short period of time after the partnership incurs or assumes the liability or another liability, one or more partners of the partnership, or related parties to a partner, in substance bears an economic risk of loss for the liability that is disproportionate to the partner's interest in partnership profits or capital; and

(ii) the transactions are undertaken pursuant to a plan that has as one of its principal purposes minimizing the extent to which the partner is treated as making a transfer of consideration to the partnership that may be treated as part of a sale under the proposed regulations. Prop. Treas. Reg. § 1.707-7(j)(8).


a. The proposed regulations amend the disclosure requirements under the existing disguised sale regulations to require disclosure if there is a transfer of property by a partner to a partnership, and by a partnership to a partner, within a seven-year period instead of within a two-year period, as currently provided for in Treas. Reg. § 1.707-3(c)(2) and Treas. Reg. § 1.707-6(c). Prop. Treas. Reg. § 1.707-7(k).

b. Similarly, the proposed regulations provide that, when a partner transfers consideration to a partnership and the partnership transfers consideration to another partner within a seven-year period, the partners treat the transfers other than as a sale for tax purposes, and the transfer of consideration by the partnership is presumed not to be a guaranteed payment for capital, within the meaning of Treas. Reg. § 1.707-4(a)(1)(ii), is not a reasonable preferred return within the meaning of Treas. Reg. § 1.707-4(a)(3), and is not an operating cash flow distribution within the meaning of Treas. Reg. § 1.707-4(b)(2), then the transfers must be disclosed in accordance with the disclosure requirements of Treas. Reg. § 1.707-8.

(i) Disclosure is not required, however, if the transfers fall within the exceptions for terminations of a partnership,
formation of a partnership, or transfers to and by service partnerships, discussed above.

c. The proposed regulations also amend Treas. Reg. §§ 1.707-5 and 6 of the existing regulations to require disclosure if a partner transfers property to a partnership and the partnership assumes or takes subject to the liability, or a partnership transfers property to a partner and the partner assumes or takes subject to the liability (whether or not the liability is a qualified liability), within a seven-year period and the partner or partnership does not treat the transaction as a sale for tax purposes.

6. Effective Date. The proposed regulations would apply to transactions with respect to which all transfers that are considered part of a sale occur on or after the date the regulations are published as final regulations.