1985

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Repository Citation
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THE FEDERAL INCOME TAX CONSEQUENCES OF THE ADMISSION OF A NEW PARTNER AFTER THE 1984 ACT

Glenn E. Coven

Reflecting state law, the taxation of partnerships is based upon a blend of entity and aggregate conceptions of partnerships. The entity approach, as in the taxation of corporations, characterizes transactions involving a partner as occurring between that partner and the single partnership entity. Under the aggregate approach, the partnership is ignored and such transactions are treated as if they were between that partner and of the other partners individually.

As subchapter K was originally enacted in 1954, the aggregate approach generally controlled the taxation of partnership operations. Transactions between a partner and the partnership, however, generally were subject to tax in accordance with the entity conception. This presumption in favor of the entity approach was adopted because of its relative simplicity and because the tax avoidance potential of the entity approach was not viewed as materially different from the result that could be obtained under corporate form. However, the parties were frequently permitted to elect an alternative pattern of taxation that approximated the results of an aggregate approach. For sales of partnership interests and distributions, § 754 of the Internal Revenue Code permitted partnerships to choose between these patterns of taxation by making a one time election. Greater flexibility was extended to transfers of property to partnerships. Under § 704(c) (2) the partners could agree to specially allocate precontribution gain or loss, in whole or in part, on a property by property basis.

The trend of recent legislation affecting the taxation of partnerships, and particularly the 1984 Act, has been to reduce the flexibility previously available to partners to adjust their relative tax burdens. Most of the changes that have occurred have been designed to compel the use of the aggregate approach in the taxation of an increasing variety of transactions, particularly when shifts in ownership have occurred. The general effect of these changes has been to substantially increase the complexity of the taxation of partnerships. Although many of the statutory amendments were precipitated by abuses originating in the tax shelter industry, the changes generally affect all partnerships.

A secondary consequence of the recent statutory modifications of subchapter K has been to reopen the gap between the taxation of partnerships and the taxation of subchapter S corporations. In 1982 Congress made a substantial effort to conform the patterns of taxation of these two conduit entities. However, the 1984 modifications in the partnership rules have not been accompanied by amendments to subchapter S. As a result, some of the differences that the 1982 legislation eliminated have now been reintroduced.
The Allocation of Income from Contributed Property

Prior to 1984 partners had almost infinite flexibility in allocating income and loss inherent in property at the time it was contributed to the partnership among the several partners. Applying the aggregate approach, the partners could agree that gain or loss inherent in contributed property would be allocated for income tax purposes solely to the contributor of the property. Under the entity approach, absent such an agreement, the partnership could allocate gain or loss attributable to contributed property in the same manner as all other items of partnership income and expense could be allocated. Thus, the partnership could make any allocation it desired provided that the allocation was accompanied by a substantial economic effect. Because the partnership could choose either method, or a combination of both, relatively little attention was paid to the operation of the aggregate approach in complex circumstances.

In 1984 Congress amended § 704(c) to require the use of aggregate approach to the allocation of precontribution appreciation and depreciation. Under the revised section, "income, gain, loss, and deduction with respect to property contributed to the partnership by a partner" must be allocated to "take account of the variation" between the basis of the property and its value at the time of contribution. Since the meaning of this phraseology had not been fully explored under prior law, many unanswered questions have been created by this amendment. In addition, the legislative history suggests that in many, as yet unspecified, circumstances the Treasury Department may by regulation waive strict adherence to the new rule. Since the aggregate approach is far more complicated to use than was the entity approach, this amendment has substantially increased the complexity of accounting for partnership operations, particularly where the assets of a going business are contributed to a preexisting partnership.

The problem that the Treasury Department perceived in the use of the entity approach was that the contributor of relatively low basis property would in effect be able to benefit from a step up in the basis of that property without having recognized precontribution gain. As a result, the incidence of tax could be shifted to relatively high basis partners for the life of the partnership even though that shifting of tax liability was not accompanied by any economic effect whatsoever. The problem can be illustrated by a simplified example. Upon the formation of a A-B partnership, A contributed property having a value of $10,000 and a tax basis of $4,000 and B contributed property having a value and basis of $10,000. Partnership profits and losses are to be shared equally. Under the entity approach permitted by prior law, A and B could agree that any gain realized on the disposition of the A asset would be allocated in accordance with the general profit sharing ratio. Thus, if the asset were sold for $10,000, $3,000 of gain would be allocated to each A and B. In effect, A would be obtaining the temporary use of $3,000 of basis that in fact was contributed by B and would thus be shifting one half of his taxable gain to B.

If both contributed properties were depreciable, A and B might also agree
that all depreciation deductions would be allocated equally between them. Potentially, $7,000 of depreciation could be allocated to each A and B (assuming that A's basis for his partnership interest had been increased by a partnership level borrowing). Again, A would be obtaining the tax benefit of $3,000 of the basis contributed by B. Correspondingly, B would have lost that tax benefit for the duration of the partnership and would thus have been temporarily overtaxed. As a result, the allocation of depreciation deductions in accordance with the entity approach would permit A to shift $3,000 of taxable income to B.

Under prior law, the optional rule described in § 1.704(c) (2) of the Regulations. A and B could eliminate the shifting of tax liability attributable to the precontribution appreciation by agreeing to allocate the first $6,000 of gain realized on disposition of the A asset to the contributor A. Similarly, if the property had a basis in excess of its value at the time of contribution, the parties could agree to allocate an equivalent amount of loss on the disposition of the property to the contributor. If the property were sold for $8,000, an ideal allocation would be to attribute a gain of $6,000 to A and to allocate $1,000 of loss to each of A and B. However, such an ideal allocation would involve the allocation of hypothetical gains and losses which the regulations barred under the so called "ceiling" rule. Thus, on these facts the maximum allocation that would be permitted would be an allocation of $4,000 of gain to A.

Where the property was depreciable, an ideal allocation would limit the depreciation deductions allocable to A to $4,000 while permitting an allocation of $10,000 of deductions to B. However, to properly correct for the disparity between value and basis, such an allocation could not be accompanied by an underlying economic effect. If the additional $6,000 of deductions that were allocated to B reduced B's capital account at a rate faster than A's capital account were reduced, the value in the partnership assets improperly would be shifted to A. This ideal corrective allocation apparently was not permissible under the general allocation rules of § 704(b) because § 704(b) allocations require an accompanying economic effect. Nor, apparently, would such an allocation have been permissible under the prior law version of the § 704(c) aggregate approach. Even where the high basis property had been contributed to the partnership, there was not precontribution appreciation in that property to be allocated under § 704(c). Rather, the regulations contemplated a different, and less precise approach. The regulations expressly permitted the allocation of all depreciation deductions attributable to contributed low basis property to the high basis partner. Thus, the full potential depreciation of $4,000 on the A asset could be allocated to B even though that allocation was not accompanied by an underlying economic effect.

Section 704(c) appears to require allocations that eliminate all disparity between the value and basis of contributed property. Nevertheless, the abuses that the amendment of § 704(c) was designed to prevent are only present where there is a variation in the disparity among partners. Even the existing regulations contemplate that allocations will be made only to the extent of equal-
izing the disparity among partners and not to the full extent of eliminating the
disparity between the value and basis of the contributing partner’s interest. For
example, assume that the property contributed by A in the foregoing example
produces depreciation deductions of $800 over two years and is thereafter sold
for $9,000. The depreciation deductions will have been allocated entirely to B,
reducing the basis in his partnership interest to $9,200. The disposition of the
property will produce a gain of $5,800. The existing regulations assume that the
special allocation of gain to A will be limited to the difference between the
actual basis of the property at the time of disposition and the basis that the
property would have had had it been purchased for its fair market value and
depreciated over the same period of time. Assuming that the property was
depreciated on a straight-line basis over ten years, that hypothetical depreciated
basis would be $8,000. Thus, the existing regulations contemplate an alloca-
tion of gain to A of $4,800 ($8,000 minus $3,200) notwithstanding that the
precontribution appreciation was $6,000. Under the existing regulations the
further $1,000 gain could be allocated among the partners in any manner
permitted by § 704(b).

The legislative history to the amended § 704(c) indicates disagreement with
this aspect of the existing regulations. See Joint Comm. on Taxation, General
Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,
General Explanation). The General Explanation suggests that an amount of
gain should be allocated to A that will result in conforming the disparity
between the basis and value of A’s partnership interest to the similar disparity in
B’s partnership interest. Since the basis of B’s partnership interest is $9,200, it
appears that the Treasury will require that $5,200 of the gain attributable to the
disposition of the A asset be specially allocated to A. That result may be
achieved under the regulations by requiring an allocation of the entire amount
of precontribution appreciation less the amount of depreciation that has been
specially allocated to the high basis partner. On the facts assumed here, that
allocation would be of $6,000 minus $800 or the $5,200 needed to raise A’s
basis to equivalence with B’s.

Pending the issuance of regulations under the amended § 704(c), the
legislative history indicates that partnership allocations will not be challenged if
they are made in accordance with the existing regulations. Since the existing
regulations are permissive, this footnote to the legislative history is apparently
intended to require partnerships to make the maximum allocation that would
have been permissible under the regulations to old § 704 (c) (2). Needless,
perhaps to observe, no one really knows what allocations are permissible under
prior law. In the situation just considered, however, it would appear that a
partnership would only be required to make a special allocation to A of the
$4,800 amount contemplated under the existing regulations and not the $5,200
amount indicated by the legislative history to the amendment.

If both A and B had contributed property having a basis of $4,000 and a value
of $10,000 and the sale of those properties at the time of contribution would produce equal amounts of ordinary income and capital gain, it does not appear that the abuse at which the amendment of § 704(c) was directed would exist. One possible way that the regulations could ease the burden of compliance with the new provision would be to exempt partnerships from the application of this provision when the ratio of basis to value for all partners is comparable. However, under the existing regulations, in this circumstance a special allocation of precontribution gain to both A and B would be permissible. Accordingly, pending regulations it would appear that a partnership would be required to provide for special allocations with respect to both contributed properties.

It is likely that the regulations under § 704(c) will encourage, if not require, elimination of variations in the disparity between value and basis as rapidly as possible. That objective will require a substantial revision of the rules presently contained in the regulations. Under the existing regulations special allocations can only be made with respect to items of income and expense attributable to the specific property contributed. For example, if the property contributed by B were sold for $15,000, that gain could not be specially allocated to A for the purpose of eliminating the disparity between the basis and value of A's partnership interest. Rather, the elimination of that disparity could only be accomplished through allocations of depreciation and gain attributable to the asset A contributed. The General Explanation states that the regulations are to permit a more rapid elimination of disparities by allowing special allocations attributable to property other than the contributed property. Although the legislative history addresses this accelerated elimination of disparities as an option to be made available to the partnership, it would not be surprising if the regulations attempted in some manner to encourage partnerships to exercise that option. However, the simplification of record keeping by the partnership through the early elimination of the obligation to comply with § 704(c) may be encouragement enough.

Under the existing regulations, a special allocation must be made with respect to each separate item of contributed property. For example, assume that the property contributed by A actually consisted of two items of property, one having a value of $4,000 and a basis of $3,000 and the second having a value of $6,000 and a basis of $1,000. If the second property was thereafter sold for $7,000, apparently the entire $6,000 gain thereby produced could not be specially allocated to A in order to eliminate entirely the disparity between the basis and value of his partnership interest. Rather, only the $5,000 precontribution appreciation in the specific property could be so allocated. The allocation of the remaining $1,000 would have to comply with the substantial economic effect requirement of § 704(b). The legislative history to the revision of § 704(c) indicates that the Treasury may permit (to an unknown extent and in unknown circumstances) the aggregation of different properties to produce a single amount of gain to be allocated pursuant to the requirement of § 704(c). It is not clear how such an aggregating provision would operate but presumably the regulations would permit the partnership in the above example to calculate
for A an overall precontribution gain of $6,000 that is subject to the mandatory allocation and to allocate the first $6,000 of gain realized on the sale of any of the properties contributed by A to A in order to eliminate the disparity between the value and basis of his interest. In combination with the permission to allocate gain attributable to property other than contributed property, such an aggregation provision might simply permit the allocation of the first $6,000 of gain from any source derived by the partnership to A in order to eliminate his disparity.

Such an aggregation approach would accomplish a variety of objectives. First, the burden of compliance with § 704(c) would be vastly simplified through an appropriately drafted aggregation rule. Second, the aggregation of gain would provide a vehicle for eliminating the disparity more rapidly than would an allocation attributable to each specific property. Third, some elements of gain will be extremely difficult for § 704(c) to reach unless an aggregate approach is adopted. For example, in one recent case a letter of intent to finance a construction project was contributed to a partnership in exchange for a partnership interest. *Stafford v. United States*, 727 F.2d 1043 (11th Cir. 1984). The court treated the letter of intent as property rather than services and thus permitted the contributing partner to defer recognition of gain on receipt of the partnership interest. However, since the partner did not have any material tax basis in that property, today such a contribution would be subject to the allocation rules of § 704(c). However, it is not all clear how the partnership will ever recognize gain with respect to that contributed property. While it is uncertain how the regulations will attempt to deal with such items of property, an aggregation approach would seem to be a likely vehicle.

**Ascertaining the Value of Contributed Property**

Because the contribution of property to a partnership is a nonrecognition transaction under § 721, under prior law the parties were not required by the income tax laws to value contributed property with precision. The valuation was important only in adjusting the economic interests of the partners and only had to be accurate enough to satisfy the partners. However, strict compliance with the amended § 704(c) requires an accurate valuation of each and every asset contributed to a partnership.

When an existing business is transferred to a partnership, the burden to complying with this requirement is quite substantial. For example, assume that Attorney C combines his existing law practice with the DEF partnership. The assets transferred include not only furniture, books, and paintings of deceased Supreme Court judges but also accounts receivable, work in process and goodwill. In order to comply strictly with § 704(c) the parties must value each asset transferred to the partnership, determine the asset’s basis, if any, and thus determine the gain or loss inherent in each asset with sufficient accuracy to defend that computation upon an audit.

The General Explanation attempts to relax this requirement by providing that
the Internal Revenue Service will respect the valuation of contributed property agreed upon by the parties and reflected in the partners' capital accounts where that value is established through arms' length negotiations. Although the legislative history appears to address only the contribution of a single item of property, it is highly probable that the regulations will also provide that an allocation of the amount of the capital account established for a new partner over all contributed property will also be respected if that allocation is not unreasonable.

Even if the allocation by the parties is respected, compliance with §704(c) will still require the identification of each of the assets transferred to the partnership and an allocation of their agreed aggregate value to each of those properties. It is anticipated that the Internal Revenue Service will require a statement embodying this allocation to be filed with a partnership return for the year of the contribution.

Waiver of Strict Compliance

The General Explanation to §704(c) acknowledges that in some situations the burden of complying with the new provision will outweigh the tax avoidance potential of partnership transactions. Accordingly, the legislative history specifically authorizes the Treasury to waive strict compliance with the new rules in two specific circumstances. First, the committee reports suggest that the Treasury should adopt a de minimus rule pursuant to which minor discrepancies between basis and value would be ignored. If the aggregate value of contributed properties does not vary by more than 15% from the aggregate basis of those properties and the overall appreciation or depreciation does not exceed $10,000, compliance with §704(c) may be waived, according to the committee reports. The reports also indicate that this de minimus rule will not be available to tax shelter partnerships. Presumably, the regulation will bar tax shelters as defined in §6661 from taking advantage of this waiver.

If compliance with §704(c) is waived, the partners would be free to allocate gain and depreciation attributable to contributed property in the same manner as if that property had been purchased, that is, pursuant to §704(b). However, it is possible that the Treasury will not permit the waiver of compliance with §704(c) where the partnership attempts to specially allocate precontribution gain to a noncontributing partner.

The legislative history suggests a second circumstance when the Treasury may waive compliance with the more complex rules governing the mandatory allocation of depreciation when it appears that allocations of precontribution gain or loss will be sufficient to eliminate the disparity between value and basis within a reasonable period of time. When the property contributed to the partnership is a wasting asset that will be retained by the partnership rather than sold, allocations of gain or loss will never eliminate the disparity between value and basis. In that circumstance, the disparity may only be eliminated by allocations of depreciation to the high basis partner or by allocating gain
derived from sources other than the contributed property to the contributing partner. Rather than define the circumstance in which allocations of depreciation will be waived, the regulations might condition this partial waiver of compliance upon an election to aggregate properties and allocate gain to the contributing partner in a manner that will eliminate the disparity between the value and basis as rapidly as possible.

**Accounts Receivable**

By its terms, the amended § 704(c) applies to all contributed "property." While it is entirely clear that the new provision applies to contributed accounts receivables, it is not fully clear how broadly the notion of property will be defined for this purpose. Under the simultaneously enacted § 724, discussed immediately below, the character of certain property contributed to a partnership is preserved. New § 724 applies to "unrealized receivables," among other things. For the purposes of this section, the Code incorporates the extremely broad definition of unrealized receivables contained in § 751(c).

It seems likely that the scope of the mandatory allocation rule under § 704(c) will be as broad as the scope of § 724. Accordingly, partnerships may be required to identify and value work in process and other equally amorphous items of value contributed to the partnership. Treating work in process as an item of property containing precontribution appreciation and requiring an allocation of partnership income to the contributing partner with respect to that item will, of course, increase the amount of ordinary income that must be specially allocated to a newly admitted partner.

**Preserving the Character of Income and Loss Generated by Contributed Property**

In general, the character of income derived by a partnership is determined at the partnership level. See § 1.701-1(b) of the Regulations. The Treasury has long been concerned that this rule, and the similar rule applicable to S corporations, was susceptible to abuse. For example, the Treasury was concerned that an individual who was a dealer in real property might form a partnership consisting of one or part of members of his family that would not have dealer status. The individual might then transfer inventory to the partnership which the partnership could subsequently sell at capital gains rates. In the reverse situation (a distribution of property from a partnership to a partner) the character of the distributed property is preserved under § 735 which prevents a partner from converting ordinary income of the partnership into a capital gain through selective distribution of property.

Under § 724, added by the 1984 act, the character of income and loss on property contributed to a partnership is preserved in the hands of the partnership for three specific kinds of property. Unfortunately, the tainting rules applicable to each category of property are slightly different.
If contributed property is an unrealized receivable in the hands of the contributing partner, gain or loss recognized by the partnership with respect to the property will be treated as an ordinary income or loss regardless of how the character of the property would otherwise have been determined. For this purpose, the definition of an unrealized receivable is the same as that contained in § 751(c). Under the regulations to that provision, unrealized receivables has been given an extremely broad definition and includes all rights to payment for goods or services even though the work has not been completed and the right to bill has not matured.

The taint on contributed unrealized receivables persists forever. The entire amount of any income or loss attributable to a contributed unrealized receivable is treated as ordinary income or loss. For example, a cash basis partner contributes to the partnership and account receivable for $100 which the parties value at $60 because of uncertainties concerning the collectability of the account. If the account is collected several years later in full, the entire $100 apparently is to be treated as ordinary income. Presumably, however, under § 704(c), only $60 of the income attributable to the receivable must be allocated to the contributing partner since that amount represents the precontribution appreciation in the value of the property. The remaining $40 of income should be allocable pursuant to § 704(b).

Similarly, if the contributed property was inventory in the hands of the contributing partner, any gain or loss realized by the partnership will be treated as ordinary income or loss. The definition of an inventory item for this purpose is the same as that contained in § 751(d) (2). That definition is far broader than might be suggested by the use of the word inventory. Under § 751(d) (2) (B), for example, the word inventory includes any property other than a capital asset or property described in § 1231. The regulations make clear that for the purposes of § 751(d) (2) the word inventory includes all realized, or accrual method, receivables.

In contrast to the rule applicable to unrealized receivables, the taint attaching to contributed inventory items persists only during the five year period beginning on the date of the contribution. But, as with the treatment of unrealized receivables, the taint on contributed inventory items extends to the entire amount of any income or loss attributable to that item during the five year period. For example, assume that a partner contributes an inventory item with a basis of 40 and a value of 100 to the partnership and the item is sold within the five year period for $125. Even if the partnership is not a dealer in such property, the entire $85 of gain will be treated as an ordinary gain. Under § 704(c), $60 of the gain must be allocated to the contributing partner but the remaining $25 of gain may be allocated under § 704(b). Similarly, if the property were sold for $30, producing a loss of $10, the loss would also be an ordinary loss. That loss would not be subject to § 704(c). If the property had been held for over five years, and was a capital asset in the hands of the partnership, the entire amount of the gain or loss would be a capital gain or loss.
If a partner contributes a capital asset to a partnership and the basis of the asset exceeds the value of the property at the time of contribution, any loss (but not any gain) recognized by the partnership on the disposition of the property is to be treated as a capital loss. In common with the rule applicable to inventory items, the taint on capital loss property persists for only a five year period.

In contrast to both preceding rules, the taint on capital loss property only applies to dispositions at a loss. If the property is sold at a gain but constitutes an ordinary income asset in the hands of the partnership, any gain will be an ordinary gain. Also in contrast to the two preceding rules, the taint on capital loss property is limited to the amount of loss inherent in the property at the time of its contribution. Any further loss will be determined by the character of the property in the hands of the partnership. For example, assume that a partner who is not a dealer in real property contributes land to a partnership that does have dealer status. The property has a tax basis of $100 and a value at the time of contribution of only $60. Thereafter the property is sold for $40. Of the $60 loss on the disposition of the property, $40 will be a capital loss and $20 will be an ordinary loss. Under § 704(c), the entire $40 loss must be allocated to the contributing partner while the balance of the loss may be allocated under § 704(b). Assume that instead the property is sold for $125. The $25 gain will be an ordinary gain and may be allocated among the partners under § 704(b).

The taint of § 724 cannot be avoided by converting the property into other property in a nonrecognition transaction. The taint applicable to the contributed property will also attach to the property exchanged for the contributed property for the same period of time that would have been applicable to the original contributed property. For example, if the contributed property is exchanged for other property in a like-kind exchange under § 1031, the property received will also be treated as tainted inventory or capital loss property.

On the face of § 724(d)(3) it is not entirely clear how the tainting rule of § 724 is to be coordinated with the similar taint created by § 735 on the distribution of property. For example, assume that an inventory item is contributed to a partnership that is not a dealer in such property. The partnership thereafter distributes the property to another partner who is also not a dealer in such property. Under § 735 gain or loss on the disposition of the distributed property by the second partner will be ordinary income if the property was an inventory item in the hands of the partnership. However, in this case, the distributed property was not inventory in the hands of the partnership; rather it was an inventory item in the hands of the contributing partner and for that reason as ordinary income asset in the hands of the partnership. Literally, therefore, it might be argued that the second partner would be entitled to capital gains on the disposition of the property, although that result would not have been intended by Congress. The general explanation suggests that the taint created by § 724 will remain with the property in the hands of the distributee partner and thus prevent the realization of a capital gain until five years have expired from the time the property was contributed to the partnership. It might be observed that such a construction of § 724 is more favorable than if § 735 were applicable to
the distributed property. If § 735 were applicable, the five year tainting period would begin again from the time the property was distributed by the partnership which would seem an improper result.

The Allocation of Partnership Losses

As a direct result of increasing concern over tax sheltering activities, much of the legislative and regulatory activity in the past few years has addressed the allocation of losses within a partnership. In general, the newly enacted provisions are correct in principle although they add enormous complexity to the taxation of partnerships. This increased complexity of the taxing system must be counted as one of the hidden costs of the tax shelter industry. Even if legislative reform eliminates the incentive or ability to shelter income, these new provisions will undoubtedly remain a part of the Code.

Traditionally, the assumption of deductible liabilities has not been properly taxed under the nonrecognition provisions of the Code. Under the general principles of the taxing system applicable to indebtedness, when a liability is assumed as part of the consideration for the transfer of property, the transaction is viewed as though the transferee paid cash in the amount of the liability assumed and the transferor used that cash to discharge the indebtedness. When the liability would be deductible if paid by the transferor, the constructive payment resulting from the transfer of the property should also produce a deduction to the transferor.

During the first quarter of a century following the adoption of the 1954 Code, no distinction was drawn under the nonrecognition provisions between the assumption of deductible and nondeductible liabilities. The nonrecognition provisions properly deferred tax on the additional amount realized by the assumption of the liability. This was accomplished by reducing the basis of property received by the transferor in the exchange, whether the property received was stock in a corporation or a partnership interest. However, the nonrecognition provisions did not defer the deduction to which the transferor would be entitled and, as a result, the transferor was over taxed.

For corporations, the over-taxation of the transferor was largely eliminated by the enactment of § 357(c)(3) which barred a basis reduction in stock when the liabilities assumed were deductible. By increasing the basis in the stock, the tax loss to which the transferor was entitled was preserved although its character was converted to a deferred capital loss. Prior to 1984, however, similar relief was not extended to partner transferors when the partnership assumed a deductible liability.

In 1984, Congress addressed this treatment of partner transferors in part through an expansion of the scope of § 704(c) and in part through an expansive committee report. First, § 704(c) was expanded to provide that deductions attributable to liabilities assumed by the partnership must be allocated to the contributing partner in the same manner as income from contributed accounts receivable must be allocated. Second, the legislative history to § 704(c)
contains the somewhat extraneous statement that accounts payable contributed by a cash method partner are no longer to be treated as liabilities for the purposes of § 752.

The extension of the principle of § 704(c) to transferred accounts payable is consistent with the prohibition against the retroactive allocation of losses contained in § 706. It is not entirely clear, however, whether the scope of § 704(c) will be comparable to the scope of § 706.

By its terms, § 704(c) is applicable to transfers of "accounts payable and other accrued but unpaid items." That language might be read as suggesting that the only liabilities subject to the mandatory allocation rule are liabilities that have sufficiently matured to have been accruable by an accrual method taxpayer. On the other hand, the revision of § 706(d), discussed below, requires the tax benefit for certain expenditures, such as compensation for services and property rentals to be "accrued" on a daily basis and allocated to partners in accordance with their interest in the partnership on each day. In some situations this anti-retroactivity feature of § 706 will bar the claiming of losses by newly admitted partners even though the liability was not properly accruable until after the partner entered the partnership.

Similarly, the definition of unrealized receivables subject to the character maintaining rules of § 724 is far broader than properly accruable account receivables, extending to the value of work in process. If the definition of the accounts receivable that are subject to the mandatory allocation rules of § 704(c) is conformed to this broader definition, the definition of the accounts payable that are to be subject to § 704(c) may similarly be expansive.

In contrast to § 706, § 704(c) does not expressly address the consequences of the withdrawal of a contributing partner from a partnership before the tax deduction attributable to a contributed account payable is realized by the partnership. The General Explanation, however, suggests that, in common with § 706, the payment of the liability must be capitalized, rather than deducted by anyone, and added to the basis of all partnership assets in accordance with the allocation rules of § 755. As in the case of § 706, a matter discussed below, it is not at all clear how that allocation is to be made.

The effect of excluding deductible liabilities from the application of § 752 is to prevent a reduction in the basis of a partner’s interest in the partnership upon the assumption of those liabilities by the partnership or upon the subsequent discharge of the liability. In common with the consequences of § 357(c) (3) the effect of this rule is to preserve to the contributing partner the loss attributable to the transferred account payable. Of course, when the partnership discharges the liability, thus generating the income tax deduction, the contributing partner’s basis will be reduced by virtue of the allocated loss. However, because his basis will not have previously been reduced by the assumption of the liability, he will have a sufficient tax basis to be able to claim that loss.

Under the pre-1984 ruling position of the Internal Revenue Service, the year end basis of a partner’s interest in the partnership was increased under § 752 by the amount of deductible liabilities of the partnership at the end of the year. See
Rev. Rul. 60-345, 1960–2 C.B. 211. As a result, a partner’s basis for claiming losses might be increased if a partnership incurred but did not pay normal operating expenses at the end of the year. The General Explanation referred to that revenue ruling with disapproval. Presumably, the Service is considering whether that ruling should be modified or revoked.

Retroactive Allocations of Partnership Losses

Under the general applicable rules of subchapter K, partners are not required to determine how profits and losses for the year shall be shared until the date upon which the partnership return is due. Code § 761(c). The allocation thus agreed upon generally will be respected under § 704(b) if the allocation is accompanied by a substantial economic effect. Prior to 1976, it was unclear whether these general rules could be used to allocate losses to a partner who was admitted to the partnership after the loss had been incurred. While such “trafficking in losses” generally is prohibited under the Code, it appeared permissible under the general rules of §§ 761 and 704.

In 1976, § 706 was amended to make clear that these so called retroactive loss allocations were not permissible. Rather, allocations of partnership income were required to take account of changes in the ownership of partnership interests, including the admission of a new partner. The relatively simple concept embodies in this amendment of § 706, however, has proven difficult to implement. For example, assume that calendar year partnership A-B-C, consisting of three equal partners, incurs a loss of $2,000 in each month. On October 1, a partner D is admitted to the partnership for a cash contribution equal to 25% of the net worth of the partnership and the partnership allocates to D 25% of partnership profits but 90% of partnership losses. The one thing that is entirely clear under § 706 is that the partnership cannot allocate to D losses incurred prior to his admission to the partnership. Accordingly, the maximum amount of loss that may be allocated to D would be the $6,000 loss incurred in October, November and December.

The 1976 legislation, however, did not coordinate this new rule of § 706 with the general allocation rules permitted under § 704(b). Nevertheless, it seems entirely clear from the purpose of the amendment of § 706 that § 706(c) only bars the allocation of losses incurred prior to a change in partnership interests to the period following that change. Section 706(c) thus should not bar the special allocation of 90% of the partnership losses to D provided that the allocation only pertains to the final quarter of the partnership year. Similarly, § 706 should have no application to the allocation of partnership losses among A, B and C. Thus, if in December the partners agree that 50% of partnership losses for the first three-quarters of the year should be allocated to C, § 706 would not bar that allocation. If the allocation had substantial economic effect under § 704(b) the allocation would be respected.

In Lipke v. Commissioner, 81 T.C. 689 (1983), the Tax Court held that the amendments to § 706 did not control the allocation of income and loss among
existing partners when there were no changes in the partners capital interests for the year. That decision was favorably mentioned in the legislative history to the 1984 Act.

It remains unclear, however, how §§ 704 and 706 are to be coordinated when the capital interests of existing partners change during the year. Assume that instead of admitting new partner D, partner C made a capital contribution to the partnership and in return the partnership allocated 90% of partnership losses to him. In Lipke, the Tax Court held that § 706 barred a retroactive allocation losses, not only to new partners, but also to existing partners that made additional capital contributions. Although in that case the additional contribution was made simultaneously with the admission of new partners, the reasoning employed by the Tax Court suggests that this factor did not control its decision. Rather, the Court held that an increased partnership interest to an existing partner should be treated in the same manner as a new interest obtained by a new partner. If that analysis is correct, it would mean that partner A could not be allocated a 90% interest in partnership profits and losses for the entire partnership year if he makes an additional capital contribution to the partnership, although such an allocation to him would be permissible had he not made a new capital investment.

Notwithstanding the scope of the opinion in Lipke, however, it would appear that in this respect the decision should be confined to the facts before the court. In that case, the old partnership interest had been acquired for an investment of only $34.00 and the partner's additional contribution apparently approximated $30,000. In approving the decision in Lipke, the committee reports suggests that retroactive allocations among existing partners are barred by § 706 only if the allocations are attributable to a new capital contribution by those partners. In Lipke, that relationship was evident. Accordingly, it should follow that a capital contribution by an existing partner will not by itself bar a retroactive allocation to that partner. Rather, such an allocation is barred only if the allocation is in exchange for the new capital contribution. While this limitation on the scope of Lipke seems correct in principle, in practice it may be difficult for the partners to demonstrate that a retroactive allocation was not related to the new capital contribution.

The 1976 legislation did not contain any definition of "retroactivity." In Richardson v. Commissioner, 76 T.C. 512 (1981), aff'd 693 F.2d 1189 (5th Cir. 1982), the Tax Court has indicated that the taxpayer's normal methods of accounting would control the point in time at which an item was incurred for the purpose of the anti-retroactivity provisions of § 706. Accordingly, a cash method partnership could accumulate deductions by deferring payment until the end of the taxable year. In that manner, a partner entering the partnership at the end of the year but prior to the actual payment of the items would be entitled to claim his proportionate share of those items, notwithstanding that the partnership had incurred the obligation to make those payments prior to the admission of the new partner.
The 1984 Act amended § 706 to prevent that manipulation of the definition of retroactivity. Under new § 706(d) (2), if the anti-retroactivity rule of § 706 is applicable, a cash basis partnership will be required to accrue specified items on a daily basis. Income or loss attributable to such "cash basis items" must be allocated only to partners in the partnership on the day an item is accrued. The items specified in § 706(d) (2) (B) are interest, taxes, and payments for services or the use of property. The new section also permits the Treasury to expand this list when appropriate by regulations to prevent significant misstatements of income. It will be interesting to see if the Treasury attempts to use this authority to account for the "reverse § 704(c)" situation by requiring that pre-contribution gain or loss in old partnership property must be allocated to the old partners. The proposed regulations to § 704(b) permit, but cannot require, such an allocation.

If an item is attributable in part to periods either before or after the taxable year in question, that portion of the item is to be attributed to the first and last days, respectively, of the taxable year. For example, assume that a calendar year, cash method partnership of A, B and C rents space for an annual rental of $12,000, payable in arrears on September 1 of each year. If partner D enters the partnership on August 1, 1986, and obtains a 25% interest in partnership profits and losses, the partnership may only allocate to him a deduction attributable to the rent equal to 25% of the $1,000 rent for the month of August notwithstanding that the entire $12,000 was paid and thus became deductible by the partnership after partner D had entered the partnership.

Assume further that partner C had purchased his 1/3 interest in the partnership from partner X on January 1, 1986. The $3,000 rental deduction attributable to the last quarter of 1985 is allocated to the first day of the 1986 partnership taxable year but may only be allocated to partners in the partnership on that day who were also partners in the partnership during the period to which the rent relates and only in the proportion that corresponds to their interest in the partnership during that period. Accordingly, the $3,000 rent attributable to the prior year, 1985, may only be allocated to partners A & B and each A & B may only claim 1/3 of the $3,000 deduction. The remaining $1,000 of the rental payment, which is allocable to X who is no longer a partner, may not be deducted by the partnership. Rather, that amount must be capitalized by the partnership and allocated to partnership properties in accordance with the provisions of § 755. Because of the lack of coordination with § 704(b), it is not clear whether this result can be avoided by reallocating the rental deduction for the prior year. For example, in connection with the transfer of the partnership interest from X to C, the partnership agreement could be amended to specially allocate the rental deduction to just A and B for the last quarter of 1985.

While requiring the partnership to capitalize an expense attributable to one no longer a partner may be appropriate, the cross reference to § 755 is perhaps unfortunate and will require considerable regulatory elaboration. Section 755 governs the allocation of the optional basis adjustment that is available to a partnership electing § 754 upon sales of partnership interests or certain dis-
tributions to partners. The provision itself does not specify who is entitled to the benefit of the resulting step up or step down in basis. That function is performed by §§ 734 or 743. In the case of the sale of a partnership interest, for example, the basis adjustment belongs solely to the purchasing partner. Neither § 706 nor the legislative history indicates who is entitled to benefit from the basis adjustment created by § 706. Presumably, that should depend upon the manner in which the withdrawing partner left the partnership. If the shift in interest occurred by a sale of a partnership interest, the basis adjustment created by § 706 should also be limited to the purchasing partner.

To the extent the payment must be capitalized, it will not reduce the partners' interest in the partnership. Rather, like any other capital expenditure, future deductions attributable to the capitalized amount will reduce the basis of the partnership interest of the partners to whom those deductions are allocated.

When a deductible cash basis item constitutes a prepayment that is economically attributable to a subsequent taxable year, to the extent that it is attributable, the payment is allocated to the last day of the taxable year and allocated to the partners on that day. This allocation rule, however, is subject to other provisions of the Code that disallow or defer the deduction of prepaid items. Under new § 461(i), for example, tax shelters using the cash method of accounting may not deduct a payment prior to the time that economic performance occurs with respect to the payment. Under § 267, payments by a partnership to a partner are not deductible prior to the day upon which the item is included in the income of the partner.

**Allocation of Basis; the Revision of the § 752 Regulations**

When a partnership borrows money or otherwise incurs a liability, other than a deductible liability, the partners in the aggregate are entitled to increase the bases of their partnership interests by the amount of the liability. This increase in basis must be allocated among the partners in accordance with § 1.752-1(e) of the regulations. Under those regulations, the basis increase attributable to a fully recourse borrowing must be allocated solely to general partners in accordance with their loss sharing ratio. On the other hand, a basis increase attributable to a nonrecourse indebtedness must be allocated among all of the partners in accordance with their profit sharing ratio. It has long been recognized that the sharp distinction drawn in regulations between general and limited partners and between recourse and nonrecourse indebtedness were unrealistic and susceptible to abuse.

In recent years, one of the most confusing questions to arise under the regulations has been the extent to which contractual arrangements, other than those creating the status of a limited partner or defining the indebtedness as with or without recourse should be taken into account for the purposes of the basis allocation. Specifically, questions have arisen concerning whether indemnification of a general partner by one or more of the limited partners, or guarantees by either a general or limited partner that a loan would be repaid,
could alter the basis allocation otherwise specified under the § 752 regulations.

Prior to 1983, these questions had arisen in the context of limited partners attempting to obtain an increase in basis when the partnership borrowing was with recourse. In those cases the Internal Revenue Service and the courts had agreed that the collateral agreement did not affect the allocation of basis because the agreement did not convert the limited partner into a general partner and only general partners were entitled to a basis increase attributable to recourse indebtedness. Nor were these arrangements regarded as agreements by the limited partners to make additional capital contributions to the partnership, which would permit a basis increase to the limited partner, because the agreements required payments to the general partner or to the lender but not to the partnership. *Ina L. Block*, T.C. Memo 1980-554, and *Richard C. Brown*, T.C. Memo 1980-267. See also Rev. Rul. 69-223, 1969-1 C.B. 184.

In 1983 a very different situation was presented. A general partner had guaranteed repayment of an otherwise nonrecourse indebtedness and this time it was the taxpayer who wished the collateral agreement ignored. The Internal Revenue Service argued that the guarantee had the effect of converting the borrowing from a nonrecourse to a recourse indebtedness which would deprive the limited partners of any basis increase attributable to the borrowing. In *Raphan v. United States*, 3 Cl. Ct. 457 (1983), *rev'd in part* 759 F.2d 879 (Fed. Cir.), *cert. denied* 106 S. Ct. 129 (1985), the Claims Court rejected the government’s position although the government ultimately prevailed on the appeal. In the meantime, however, Congress inserted in the 1984 Act an instruction to the Treasury Department to revise the § 752 regulations “as soon as practicable.”

The committee reports make clear that the new regulations are not to alter the basic pattern of the regulations and, in particular, are not to attempt to deny a basis increase attributable to nonrecourse indebtedness. However, the regulations will attempt to deal more realistically with collateral agreements that alter the potential liabilities of the parties.

The committee reports do not contain much guidance as to the form that the new regulations may assume. Indeed, the only clear rule that can be discerned from the congressional action is that a general partner’s guarantee of nonrecourse indebtedness, such as was involved in *Raphan*, will cause that indebtedness to be treated as a recourse liability.

One source of guidance that will undoubtedly be examined by the Treasury Department in drafting the new regulations is the 1982 proposal by the American Law Institute on the revision of subchapter K. ALI, Federal Income Tax Project, Subchapter K, Part L, pp. 272-73 (1984). Under the ALI proposals, a nonrecourse debt that was guaranteed by any partner would be treated as a recourse debt. However, the basis increase attributable to a recourse debt would be allocated not only to the general partners but also to any limited partner who had a personal obligation to repay the indebtedness.

The ALI proposal would appear to require considerable refinement before
regulations can be drafted. For example, under the proposed rules if a limited partner guarantees repayment of a nonrecourse indebtedness, the indebtedness would be treated as a recourse indebtedness but the basis increase would be limited to the partners who were personally liable for the repayment of that indebtedness, namely, the limited partner who guaranteed it. Accordingly, by a side agreement with a lender, a limited partner could obtain the entire basis adjustment attributable to the nonrecourse loan, a dubious result. One alternative that the Treasury may be considering is to allow partners almost complete flexibility in allocating the basis adjustment attributable to a partnership level borrowing and to limit the ability of partners to claim losses through the application of the "at risk" rules instead of through the basis allocation rules of § 752.

Transactions Between the Partnership and the New Partner

Receipt of a partnership interest in exchange for services.

As with most issues of partnership taxation, the income tax consequences of the receipt of a partnership interest in exchange for services have never been clearly established. However, several recent commentators have assumed that the tax consequences are to be derived from a rigorous application of the aggregate view of partnerships. The suggested results may not be the ideal solution to the problem.

When a partner receives an interest in partnership capital in exchange for the performance of services, all recognize that the compensated partner will be subject to tax on some amount and that some combination of the partners in the partnership will be entitled to a corresponding tax benefit by virtue of the payment of the compensation. In addition, it now seems well established that the nature of the tax benefit that the partnership obtains will be determined by the nature of the services performed in the same manner as if the tax benefit were attributable to a payment of cash. Thus, the amount of the compensation may be deductible or the partnership may be required to capitalize that amount and obtain a tax benefit through depreciation or amortization. All other questions, however, remain unresolved.

The normal logic of the taxing system suggests that the amount of the compensation to the service partner should be equal to the fair market value of the partnership interest received. While that common sense answer may be correct, the regulations to § 721 imply a contrary answer. Those regulations deny nonrecognition treatment when services are contributed to a partnership and in return other partners give up the right to be repaid a portion of their "contributions (as distinguished from a share in partnership profits)." The regulation continues to provide that the service partner will be subject to tax under § 61 on the value of the capital interest so transferred but, in context, the sentence can be read as equating capital with contributions and not with unrealized appreciation in partnership assets.

That reading of the regulation is not entirely unreasonable. If the service
partner is not taxed on the unrealized appreciation in partnership assets at the
time he enters the partnership, he will be taxed on that appreciation when it is
realized by the partnership or, if the pre-admission gain is specially allocated to
the old partners, upon his withdrawal from the partnership. This ambiguity may
have been resolved by the enactment of § 83. That section, admittedly governs
the transfer of a capital interest in the partnership in exchange for compensation
for services, requires that the value of the property transferred be included in the
income of the service partner. That analysis is reasonable and will likely prevail
although it is clear that § 83 was not drafted with the special problems of
partnership taxation in mind.

It is far from clear how the tax benefit attributable to this compensation can or
must be allocated among the partners. When the partner is being compensated
for services performed for an existing partnership prior to the transfer of the
capital interest, § 706 as amended in 1984 probably requires that the tax benefit
be allocated to the partners in the partnership on the day prior to the admission
of the service partner. That result seems clear when the compensation is
currently deductible. It does not appear, however, that § 706 would govern the
allocation of depreciation or amortization benefits attributable to the capital-
ization of the payment of compensation.

When the capital interest is obtained on the formation of a new partnership,
§ 706 cannot properly be applied at all. When the capital interest is obtained for
services to be performed in the future, § 706 requires that the deduction
produced by the payment of the compensation be allocated to persons who were
partners on the last day of the partnership year, which would include the service
partner.

If any amount of the deduction attributable to the compensation of the service
partner may be allocated to the service partner, there does not appear to be any
principle that limits the amount of the deduction that may be so allocated.
Indeed, it has been suggested that the tax consequences to the service partner
may be eliminated by allocating to him the entire amount of the deduction
generated by the payment of the compensation as a special allocation under
§ 704(b). While at first glance that result may appear improper, on reflection it
does not seem that such an allocation would offend any principle of income tax
policy. For the allocation of the deduction to be respected for income tax
purposes, the tax allocation must be accompanied by a corresponding reduction
of the partner’s capital account. Thus, if the entire amount of the deduction
were allocated to the service partner, his capital account would be entirely
eliminated. The net effect of the transaction would be that while the partnership
had purported to transfer a capital interest to the service partner, in fact no such
transfer had occurred. Rather, all the service partner would have received
would be an opportunity to participate with the other partners in the earning of
future partnership income. Since the service partner did not in fact obtain a
capital interest having any revenue value, there would be no occasion to subject
him to tax.
Some commentators have suggested that the transfer of a capital interest in a partnership having appreciated assets can trigger the recognition of gain to the partnership. Under general principles, the transfer of appreciated property in payment for services is a taxable event to the transferor of the property and he will be subject to tax to the same extent as if he had sold the property for its fair market value. Reasoning from that unquestioned principle to the partnership context, it has been suggested that the transfer of a capital interest in the partnership should be viewed as if the partnership had transferred an undivided interest in partnership properties to the service partner and the service partner had thereafter recontributed those properties to the partnership. Since an actual transfer of appreciated partnership assets as compensation for services would produce a gain to the partnership, it has been suggested that this constructive transfer should produce a similar consequence.

Say it isn’t so. The practical problems involved in computing the resulting income tax liabilities would be as monstrous as those produced under new § 704(c). If this approach were to be adopted, it would seem that the partnership would be treated as having sold an undivided interest in each and every asset of the partnership. If so, all such assets, including intangibles, would have to be identified and their relative values established.

Alternatively, perhaps the partnership would be permitted to designate which assets it is deemed to have constructively sold to the service partner. Although that flexibility obviously permits taxpayer manipulation, the partnership could in fact have compensated the service partner by an actual transfer of selected partnership assets. Accordingly there is no reason to bar the partnership from designating the assets that are treated as constructively transferred to the service partner. A similar flexibility is permitted in the application of § 751(b). The mechanics of that excessively complex provision create a constructive distribution followed by a sale of the constructively distributed properties back to the partnership. The partnership is permitted to designate the assets deemed distributed and repurchased.

This analysis of the consequences of the admission of a service partner seems erroneous. The exclusion of the contribution of services from the non-recognition provisions of § 721 is designed to prevent the deferral of tax on earned income. There is nothing in that entirely appropriate policy that suggests that the admission of the service partner is the proper occasion to accelerate a tax to the partnership or to permit the partnership to increase the basis of its assets. While the appreciation in partnership assets is in effect “being used” to compensate the service partner, that use is not distinguishable from the use of the appreciation in partnership assets when a partnership interest is sold for cash.

The income tax consequences of the admission of a service partner should be exactly the same as if the partnership had sold the partnership interest for cash to the service partner and had used that cash to compensate the partner. In that event, the service partner would be subject to tax on the value of the partnership interest received and would obtain an income tax basis in that interest equal to
its value. The partnership would be entitled to a tax benefit for the constructive payment but would not realize any gain on a constructive sale of partnership assets. The inside basis of the partnership assets would not be affected by the transaction. The net effect of the transaction would simply be a shift of basis from the old partners to the newly admitted service partner.

Regarding whether the admission of the service partner is regarded as producing a constructive sale of an undivided interest in partnership assets, the partnership will need to enter into a special allocation arrangement under § 704(b) to prevent the overtaxation of the service partner. Since that partner will have been subject to tax to the extent of the value of his undivided interest in the partnership, the remaining unrealized appreciation or depreciation in partnership assets should be specially allocated to the other partners. Such an allocation is expressly permitted by the proposed regulations under § 704(b). See Prop. Reg. § 1.704-1(b) (4) (i).

**Distinguishing Between Contributions to A Partnership, Purchases of Partnership Interests, and Sales of Property**

Because §§ 721 and 731 in combination broadly permit nonrecognition treatment of a transfer of property to a partnership and a distribution of cash or property to a partner, there has been a strong incentive to characterize transactions as contributions and distributions rather than as sales. In recent years, the Treasury has attempted to reconstruct purported contributions as disguised sales of property or partnership interests. However, the courts, recognizing that subchapter K was designed to extend flexibility to partners in arranging their transactions, generally have permitted taxpayers to achieve the consequences they sought through a formal, if not substantive, compliance with §§ 721 and 731. See *Otey v. Comm'r*, 70 T.C. 312 (1978), aff'd. 634 F.2d 1046 (6th Cir. 1980) (per curiam); *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980) and *Jupiter Corp. v. United States*, 2 Ct. Cl. 61 (1983).

For example, on the formation of a partnership, partner A transfers to the partnership property having a value of $100,000 and a negligible basis. Thereafter the partnership borrows $1,000,000 for the purpose of developing the transferred property and under § 752 partner A's basis is increased by virtue of the borrowing by $150,000. The partnership then distributes to partner A $100,000 in cash from the proceeds of the borrowing. Under §§ 721 and 731, partner A has no gain as a result of this series of transactions; the basis for his partnership interest is reduced to $50,000. In the view of the Internal Revenue Service, however, partner A has not made a contribution nor received a distribution from the partnership but rather has sold his property to the partnership and should be subject to tax on the gain.

Assume that in partnership ABC each of the partners has a basis for their partnership interests of $10,000 although the value of the interest is $20,000. The partnership wishes to admit partner D as an equal partner but has no need for further investment. If each of partners A, B and C's sell 1/4 of their
partnership interest to D for $5,000, they will each be taxable on $2,500 of
gain. Conversely, partner D may contribute $15,000 to the partnership in
exchange for a 1/4 partnership interest and the partnership may thereafter
distribute $5,000 to each of the partners A, B and C. Again, under § 731 the
distributions will not be taxable but will merely reduce the basis of their
partnership interests to $5,000. The Internal Revenue Service would like to
characterize such a transaction as a taxable sale of the partnership interest rather
than a contribution and distribution.

In 1984 Congress amended § 707(a), adding language that on its face is
utterly meaningless. The revised § 707(a) (2) (B) now provides that if there is a
contribution to a partnership and a “related” payment to the contributing
partner or another partner and if the contribution and distribution “when
viewed together, are properly characterized as a sale of property,” then the
transaction shall be regarded as a sale rather than as subject to §§ 721 and 731.

Literally, the statutory amendment merely sets forth a step transaction
doctrine that has always been embodied in the regulations. However, in the
context of the surrounding legislative history, it is clear that Congress was
intending to reverse the results of those cases that had extended favorable
treatment to taxpayers engaging in such transactions. Furthermore, the legis-
lative history contains extensive guidelines and examples, which will be
repeated and expanded upon in the regulations, for the purpose of assisting the
courts in discriminating between contributions and disguised sales in a more
satisfactory manner.

The statutory language of § 707(a) (2) (B) might be read as suggesting that
the entire transaction must be characterized either as a contribution or as a sale.
When the related distribution is substantially less than the entire value of the
property contributed, such an all or nothing approach would clearly produce an
inappropriate result. For example, in the first example above, if the partnership
distributed to partner A only $50,000 but the transaction was nevertheless
regarded as a sale, the statute might appear to suggest that partner A would be
subject to tax on the entire $100,000 received in exchange for property
($50,000 in cash and a partnership interest worth $50,000). Nevertheless, it is
clear under the legislative history to this new provision that a transaction may be
regarded as a partial sale subject to § 707 and a partial contribution subject to
§ 721. Thus, partner A would have an amount realized on the sale equal to
$50,000.

What is unclear, however, is what proportion of partner A’s basis may be
offset against the taxable proceeds of the sale. In the part sale-part gift context,
the Service permits taxpayers to offset their entire basis against the proceeds of
the sale. On the other hand, where boot is obtained in a nonrecognition
transaction, the entire amount of the gain is taxable and the basis is applied to
the nonrecognition property, in this case the partnership interest. It may be
anticipated that the Treasury will follow the analogy to boot and treat the entire
$50,000 as taxable. In that event, the partner normally would have a basis for
his partnership interest equal to the basis in the property transferred to the partnership.

Under revised § 707, the distinction drawn between disguised sales and partnership contributions will be one of degree. Whenever a partner transfers property to a partnership, it is entirely appropriate for his capital account to be enlarged by the value of the contributed property. Moreover, it will be entirely appropriate for the partnership to allocate distributions among the partners which take into account the relevant capital accounts of the partners. In some circumstances that allocation would result in the contributing partner receiving a priority of distributions from the partnership equivalent to the value of the property contributed.

Whether the series of payments is reconstructed as a disguised sale will largely depend upon how closely the distribution is related to the contribution. If a priority distribution occurs within a short period of time following the contribution, the likelihood that a disguised sale will be found increases. Similarly, if the distribution is contingent upon the profitability of the enterprise so that the contributing partner may be said to have borne an entrepreneurial risk, sale treatment is less likely to be found. Thus, where the source of the funds for the distribution lies in the operation of the business rather than an immediate partnership borrowing, sales treatment will likely not be found.

A disguised sale may be structured through the use of a partner level borrowing rather than a partnership borrowing. For example, partner A might have borrowed $50,000 from a bank, secured by the property to be contributed to the partnership, and then transferred the property subject to the indebtedness to the partnership. Under § 752(b), the assumption of a partner's liabilities by the partnership is treated as a distribution to the partner. Thus, this form of transaction also involves a contribution and a related distribution, albeit a constructive distribution. It is clear from the legislative history that such constructive distributions are also within the scope of the revised § 707 and thus may be recharacterized as a sale.

When property is contributed to a partnership subject to a liability, the constructive distribution is limited to the proportion of the indebtedness assumed by the other partners. Thus, if the contributing partner obtains a 25% interest in partnership losses, the constructive distribution would be limited to 75% of the amount of the indebtedness. In this circumstance the transaction would be treated as a part sale-part contribution and the amount realized on the sale would be limited to the 75% of the indebtedness assumed by the other partners.

Not all transfers of property subject to indebtedness to a partnership will be reconstructed as disguised sales. The legislative history to the amendment to § 707 indicates that the test to be applied will resemble the test applied to similar transactions in the corporate area under § 357(b). Thus, when the indebtedness was incurred in the ordinary course of business or otherwise was not in
contemplation of the contribution of the property to the partnership, sales
treatment will not be found. Rather, it is the subjecting of property to an
indebtedness in contemplation of the transfer to the partnership that will run
afoul of the regulations to be issued under § 707.

If there is a transfer of property or services to a partnership and in return the
partnership allocates income to the transferor partner, apparently new
§ 707(a) (2) (B) will not apply. However, the simultaneously enacted
§ 707(a) (2) (A) may apply.

Superficially, subparagraph (A) appears similar to subparagraph (B). The
new provision states that if a partner transfers services or property to a
partnership and there is a related “allocation and distribution” to the partner,
the transaction may be recharacterized, when appropriate, as a transaction
between the partnership and a nonpartner. If that recharacterization occurs, the
transaction will become taxable. Subparagraph (A), however, was designed to
resolve a problem entirely different from that addressed by subparagraph (B).
Congress was concerned that partnerships were in effect paying for services or
property through allocations of a distributive share of partnership income and
thus avoiding the requirement that such payments be capitalized.

Assume, for example, that a partner devoted a substantial amount of time to
selling additional partnership interests. If the partnership compensated the
partner for his efforts with a guaranteed payment, the partnership would be
required by § 707(c) and § 709 to capitalize rather than deduct the amount of
that payment. However, prior to 1984 partnerships took the position that if they
merely increased the partner’s income allocation percentage for the year in
which the services were performed, there was no expenditure that could be
subject to the capitalization rules. Rather, the remaining partners merely
excluded the amount allocated to the transferor partner from their incomes and
thus obtained the same after tax consequence as an immediate deduction for that
amount. Subparagraph (A) was designed to prevent that avoidance of the
capitalization requirement by treating the allocation as a § 707(a) payment.
Such payments, of course, are subject to the capitalization requirement.

Normally, subparagraph (A) will not have any effect upon the income of the
transferor partner. That partner will have been subject to tax on the income
allocated to him although recharacterizing the transaction as a sale of property
or compensation for services rather than a distributive share of partnership
income could have the effect of changing the character of the income to the
transferor partner. However, by recharacterizing the allocation as a § 707(a)
payment, the partnership will not be able to exclude that amount from the
computation of partnership income and, if the payment is properly capitalized,
the partnership will not be able to deduct that amount from partnership income.

Congress intended that recharacterization under subparagraph (A) be the
exception rather than the rule. Most transfers of services or property to a
partnership in exchange for a partnership interest will be unaffected by this new
provision. The General Explanation makes clear that the transactions covered
by subparagraph (A) are those that have the following characteristics.

(1) Where services are transferred, the payment for the services would properly be capitalized.

(2) The transferor obtains a temporary allocation of income that is designed to reimburse him for the transfer rather than provide him with a continuing interest in the partnership.

(3) The transferor obtains a prompt distribution from the partnership of the amount of the allocation that is preferential relative to distributions to other partners.

(4) The nature of the allocation and of the level of partnership income suggests that the transferor partner is virtually assured of obtaining the allocation and distribution within a short period of time and will thus not bear the usual risks associated with the conduct of the partnership's business.

The several distinct problems addressed by both subparagraphs of § 707(a) (2) are relatively easily recognized in practice. However, it will not at all be easy for the Treasury to draft regulations that accurately discriminate between normal partnership transactions and the abuses that these amendments were designed to prevent. As a result, it may be anticipated that complex and elaborate regulations will be issued under this provision that will materially complicate the admission of new partners and further reduce the flexibility of partnership operations.