REPORT #702

TAX SECTION

New York State Bar Association

Report on Proposed Section 707 Regulations
Concerning Disguised Sales of Property Through Partnerships

October 21, 1991

Table of Contents

Tax Report #702

TAX SECTION

New York State Bar Association

October 25, 1991

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20024

Dear Commissioner Goldberg:

I am enclosing a report prepared by an ad hoc subcommittee of our Committee on Partnerships commenting on the proposed Treasury regulations under section 707(a)(2).

We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

James M. Peaslee
Chair

Enclosure

Identical letter to:

The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20020

Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

cc: Abraham N.M. Shashy, Jr., Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, D.C. 20224

Thomas R. Hood, Esq.
Counsellor to the Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3316
Washington, D.C. 20224

Mary L. Harmon, Esq.
Special Assistant to Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3034
Washington, D.C. 20224

Stuart Brown, Esq.
Associate Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3527
Washington, D.C. 20224

Paul F. Kugler, Esq.
Assistant Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 5300
Washington, D.C. 20224

Michael J. Graetz, Esq.
Deputy Assistant Secretary of
the Treasury for Tax Policy
Department of the Treasury
3108 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Terrill A. Hyde, Esq.
Tax Legislative Counsel
Department of the Treasury
3064 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Judith Dunn, Esq.
Department of the Treasury
4206 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Evelyn J. Brody, Esq.
Attorney Advisor
Department of the Treasury
4013 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Tax Report #702

October 25, 1991

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Proposed Section 707 Regulations Concerning Disguised Sales of Property Through Partnerships

INTRODUCTION

This report[1] comments on the proposed Treasury regulations (the “Proposed Regulations”) issued by the Internal Revenue Service (the “Service”) under section 707(a)(2) of the Internal Revenue Code of 1986, as amended (the “Code”).[2]

BACKGROUND

Prior to the Tax Reform Act of 1984 (the “1984 Act”), contributions to, and distributions from, partnerships were governed exclusively by sections 721 and 731 and generally

[1] The report was prepared principally by Richard D. Martinson, who chaired a subcommittee of the Committee on Partnerships of the Tax Section. The subcommittee was composed of Michael J. Close, John Delaney, Larry Kahn, Keith E. Marlowe, Elliot Pisem, Joel Scharfstein, Marc D. Teitelbaum, R. Donald Turlington, Hershel Wein and Mark R. Wright, each of whom made significant contributions. Helpful comments were also provided by William Burke, Harvey Dale, Arthur Feder, Richard Leder, James Peaslee, Richard Reinhold and Michael Schler.

[2] All “section” references are to the Code, and all “Treas. Reg. §” or “Prop. Treas. Reg. §” references are to the Treasury regulations or proposed Treasury regulations thereunder.

resulted in tax-free treatment to both the partnership and the contributing partner. Despite the existence of regulatory authority under those sections permitting the Service, under certain circumstances, to treat purported contributions by and distributions to a partner as related steps in a taxable sale between the partner and the partnership,[3] the efforts of the Service to apply those regulations to subject the contributing partner to taxable sale treatment were rebuffed in a series of court decisions.[4]

Accordingly, in the 1984 Act, Congress added section 707(a)(2)(B) to the Code in order to counteract the effect of those decisions and to give the Service explicit authority to adopt regulations identifying those transactions that, although structured as contributions and distributions under sections 721 and 731, are more properly treated as sales or exchanges between

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[3] Treas. Reg. §§ 1.721-l(a) and 1.731-1(c)(3).

[4] The leading case declining to recharacterize such a transaction as a taxable sale was Otey v. Gammissioner. 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (6th Cir. 1980). Other such cases included Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980); Park Realty Co. v. Commissioner, 77 T.C. 412 (1981); and Jupiter Corp. v. United States, 2 Cl. Ct. 58 (1983). There were also decisions, decided both before and after the enactment of section 707(a)(2)(B) with respect to taxable years not governed by that provision, that did sustain recharacterization by the Service. See, e.g., Jacobson v. Commissioner. 96 T.C. No. 21 (1991); Barenholz V. Cominissioner, 77 T.C. 85 (1981). Cf. Allison v. Commissioner, 35 T.C.M (CCH) 1069 (1976) (arrangement held not to constitute a “partnership” for tax purposes because taxpayer was certain to receive distribution of only certain specified lots; distribution of lots held to be payment of compensation by other “venturer”). Conversely, the Service has also lost at least one case decided after 1984 with respect to an earlier taxable years. See Oehlschager v. Commissioner, 55 T.C.M. (CCH) 839 (1988).

a partnership and a partner acting in a capacity other than as a member of the partnership. Specifically, section 707(a)(2)(B) provides that if:

> (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
>
> (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
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> (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,
>
> such transfers shall be treated either as a transaction [between the partnership and a partner acting other than in his capacity as a member of the partnership] or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

On April 25, 1991, the Proposed Regulations were issued.[5] The preamble to the Proposed Regulations states that when a partner purports to transfer property to a partnership as a contribution, and the partnership in turn purports to transfer other property to such partner as a distribution, such transfers will be regarded as related (and thus subject to disguised sale treatment) “only to the extent their combined effect is to allow the transferring partner to withdraw all or a part of his or her equity in the transferred property.” Under this “equity-withdrawal” approach, “a contribution of property to

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[5] 56 Fed. Reg. 19055 (April 25, 1991).

the partnership will not be treated as part of a disguised sale if the transferring partner is merely converting his or her equity in the transferred property into an interest in partnership capital that is subject to the entrepreneurial risks of partnership operations.” On the other hand, if the partner's equity in nominally contributed property is not converted into a “genuine interest in partnership capital that is subject to . . . entrepreneurial risks,” any subsequent distributions by the partnership representing a withdrawal of such partner's equity interest in the transferred property will be treated as a disguised sale. The Proposed Regulations employ a “facts and circumstances” analysis in determining whether such an equity withdrawal has taken place.[6]

OVERVIEW OF THE PROPOSED REGULATIONS

1. General. A contribution of property by a partner to a partnership and a distribution of money or other consideration by the partnership to such partner will be treated as a taxable sale, in whole or in part, of the property if, based on all the facts and circumstances, (i) the partnership distribution would not have occurred absent the partner's contribution of the property and (ii) the partnership distribution is not dependent on the entrepreneurial risks of the partnership's operations. The Proposed Regulations provide a nonexclusive list of facts and circumstances that tend to prove the existence of a sale.

[6] The Proposed Regulations apply an identical analysis to transactions under section 707(a)(2)(A) involving the transfer of property by a partner to a partnership and the making of a related direct or indirect allocation and distribution to such partner. We concur with this approach.

The Proposed Regulations have reserved regulations under section 707(a)(2)(A) involving disguised payments for services.

2. Two-Year Presumption. If, within a two-year period, a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the two transfers are presumed to constitute a taxable sale of all or a portion of the property by the partner to the partnership. On the other hand, if such transfers take place more than two years apart, the transfers are presumed not to be a sale (i.e., the form of the transfers as a contribution to and distribution from a partnership is presumed to be respected). The foregoing presumptions can be overcome if the facts and circumstances clearly establish otherwise.

3. Liabilities. If, in connection with a partner's transfer of property to a partnership, the partnership assumes (or takes subject to) a liability that is not a "qualified liability," then the transfer will be treated as a taxable sale by the partner to the extent that the liability is shifted to the other partners (i.e., to the extent that the amount of the liability exceeds the contributing partner's share of such liability immediately after the transfer, under certain liability sharing rules set forth in the Proposed Regulations).[7]

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[7] Under those rules, recourse liabilities are generally allocated to a partner to the extent that such partner would be liable for such liability if all of the partnership assets were worthless and the partnership were liquidated (i.e., an economic risk of loss approach). Nonrecourse liabilities are generally allocated to a partner on the basis of either (i) the partner's predominant share of income from the property (excluding any built-in gain allocable to the partner under section 704(c) and certain special allocations of gain required under section 704(b)) or (ii) the partner's smallest percentage interest in any material item of income or gain attributable to the contributed property.

For this purpose, a “qualified liability” is generally a liability that was incurred more than two years prior to the contribution of the encumbered property to the partnership, was incurred to finance the acquisition of, or capital expenditures relating to, the property, or was incurred in the ordinary course of the trade or business to which the transferred property relates, but only to the extent such liability does not exceed the fair market value of the transferred property. Debt incurred within two years of the transfer of the encumbered property to the partnership will also generally be treated as a “qualified liability” if the facts and circumstances clearly establish that such debt was not incurred in anticipation of the transfer.

If a partnership assumes, or takes properties subject to, the non-qualified liabilities of more than one partner pursuant to a plan, each partner's share of such liabilities immediately after the transfers of such encumbered properties to the partnership equals the sum of the partner's shares of such liabilities. This “netting” rule does not apply to qualified liabilities or to any liability that is assumed or taken subject to by the partnership with a principal purpose of reducing the extent to which any other such liability is treated as a transfer of consideration under the Proposed Regulations.

4. Debt-Financed Transfers. Although the two-year presumption will generally cause a partnership distribution of cash to be treated as sale proceeds if the distributee partner has transferred property to the partnership within two years of such distribution, an exception to this rule applies where the distribution is attributable to the proceeds of a debt incurred

by the partnership within 90 days of such distribution. In such a case, the distribution is analyzed under the liability assumption rule and will be treated as sale proceeds only to the extent that the distribution exceeds the distributee partner's allocable share of the debt (as determined under the liability sharing rules outlined above). If a partnership distributes proceeds of one or more borrowings to partners pursuant to a plan, then such liabilities are aggregated in applying the rule.

5. Safe Harbor Distributions. Certain partnership distributions are generally disregarded for purposes of these rules and, thus, will not be treated as part of a taxable sale. These distributions include (i) a reasonable (generally, 150% of the applicable Federal rate) guaranteed payment for capital,[8] (ii) a reasonable preferred return,[9] (iii) a distribution of a partner's interest in net operating cash flow,[10] and (iv) a distribution to reimburse a partner for preformation expenditures.[11]

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[8] A guaranteed payment for capital is generally a payment to a partner that is determined without regard to partnership income, is for the use of the partner's capital, and is not designed to liquidate all or part of the partner's interest.

[9] A preferred return is generally a preferential cash distribution that will be matched, to the extent available, by an allocation of partnership income or gain.

[10] Net operating cash flow is generally equal to the partnership's taxable income arising in the ordinary course of business as adjusted for certain non-cash items, such as depreciation.

[11] For this purpose, preformation expenditures are limited to capital expenditures incurred during the one-year period preceding the contribution of property by the partner to the partnership, but only to the extent that such expenditures (i) are incurred with respect to the contributed property or are partnership organization and syndication costs and (ii) do not exceed 20% of the fair market value of the property at the time of the contribution.

6. Multiple Property Transfers. The Proposed Regulations expressly limit the ability of a partner to treat some transfers of property to a partnership as contributions, while treating other property transfers as sales. If the sale and the contribution are pursuant to a "plan," the Proposed Regulations will treat the transaction as being a taxable sale of an allocable portion of each of the transferred assets based on their relative fair market values. The Proposed Regulations do not provide guidance as to when a plan exists, and the two-year presumptions are not expressly applicable to this determination.

7. Outbound Transactions. The Proposed Regulations provide rules relating to disguised sales of property by a partnership to a partner. The rules are similar to the rules provided for disguised sales by a partner to a partnership.

8. Disclosure. Certain transactions are to be reported by partners and partnerships on Form 8275 or on a statement attached to the transferor's return.

9. Effective Date. The Proposed Regulations apply to transactions with respect to which all transfers considered part of a disguised sale (i.e., the contribution as well as the related distributions) occur after April 24, 1991. The Proposed Regulations state that, for transfers occurring, in whole or in part, on or prior to such date, a determination of disguised sale treatment is to be made based on the applicable statutory language and related legislative history.

RECOMMENDATIONS

I. SUMMARY

In general, we believe that the equity extraction analysis in the Proposed Regulations provides a solid framework for testing whether to treat partnership contributions and distributions as sales.[12] We recommend a number of changes in, and clarifications of, the Proposed Regulations; these would, in our view, improve the framework laid out in the Proposed Regulations and facilitate their application to the current economic and legal environment in which subchapter K operates.

First, the final regulations should clarify the scope of the disguised sale rules. In particular, they should make clear that a partnership interest under state law (or a distribution right thereunder) that is treated under the Proposed Regulations as a payment or a right to a future payment for property transferred to the partnership will be so recharacterized for all tax purposes. Thus, installment reporting of gain will be applicable to deferred distribution transfers unless the transferred property could not have been sold by the transferor under section 453 or the transferor elects out of installment reporting.

Second, it is apparent from the Proposed Regulations that an overriding emphasis has been placed on a "facts and circumstances" analysis in determining whether a transaction between a partner and a partnership should be treated as a

[12] See, e.g., Turlington, Transfers of Encumhered Property to Partnerships; Disguised Sales Under Section 707(a)(B), J. Partnership Tax'n 187 (1987).

disguised sale. We assume that this emphasis emanates principally from a desire on the part of the Service and the Treasury for the administration of the tax law to get away from a complex, over inclusive approach to regulation-writing and move toward simpler, “rough justice” notions of regulatory guidance. In this context, the “entrepreneurial risk” and “facts and circumstances” analyses are clearly appropriate, since they implicitly recognize the impossibility of devising a detailed set of rules that may be clearly applied in every imaginable situation. Accordingly, we commend the Service and the Treasury for adopting an approach that, by its very nature, is flexible enough to be applied to a myriad of fact patterns and will generally reach the “right” result in any given case. Nevertheless, we believe that the analytical tools used by the Proposed Regulations to administer the entrepreneurial risk and facts and circumstances tests may be subject to misinterpretation. For example, the general rule which relies on entrepreneurial risk fails to distinguish (1) the situation in which the subsequent distribution to a partner contributing property is funded by sale proceeds from the property that partner contributed from (2) the situation in which the distribution is funded by property or money from other partners or from nonqualified borrowings. Only the latter fact pattern was intended to be covered by section 707(a)(2)(B). Section 704(c) controls the former.

Third, although we endorse the two year presumption for and against disguised sales generally, we urge that the final regulations clarify application of the presumption. In particular, we suggest that the regulations provide guidance on the interplay of the presumption with general procedural requirements of burdens of proof, of persuasion and of going forward with evidence.

Fourth, the guidance provided by the Proposed Regulations for so-called mixing bowl transactions is inadequate and unclear. We suggest that the example illustrating such a transaction be clarified and subdivided to better illustrate the intended scope of section 707(a)(2)(B) and that another example be included making clear that the disguised sale rules will not automatically be applied to partnerships merely because the partners “anticipate” or contemplate an eventual liquidation in kind.

Fifth, we propose a number of changes to the Proposed Regulations' treatment of liabilities which we believe will conform more closely to ordinary commercial practice and to Congressional intent as reflected in the legislative history of section 707(a)(2)(B).

Finally, we suggest several other modifications to the safe harbor rules governing distributions and multiple transfers of property to and from partnerships.

Part II of this Report sets forth our general comments on the scope of the Proposed Regulations under Prop. Treas. Reg. § I.707-3 (a). Part III explores the nature of the facts and circumstances analysis of Prop. Treas. Reg. § 1.707-3(b). Part IV deals with the definitions contained in, and the operational effects of, the rules relating to liabilities under Prop. Treas. Reg. § 1.707-5. Finally, Part V contains other recommendations on certain miscellaneous aspects of the Proposed Regulations, including the Proposed Regulations' safe harbor for distributions of operating cash flow; the Report recommends that the safe harbor be expanded to include certain distributions of extraordinary proceeds.

II. SCOPE OF PROPOSED REGULATIONS -- Prop. Treas. Rea. § 1.707-3(a)(2)

The Proposed Regulations provide that:

> A transfer that is treated as a sale under paragraph (a)(1) of [Prop. Treas. Reg. § 1.707-3] is treated as a sale for all purposes of the Code (e.g., sections 453, 483, 1001, 1012, 1031 and 1274). The sale is considered to take place on the date that, under general principles of Federal tax law, the partnership is considered the owner of the property. If the transfer of money or other consideration from the partnership to the partner occurs after the transfer of property to the partnership, the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other consideration.

The Proposed Regulations (particularly Example 2 of Prop. Treas. Reg. § 1.707-3(g)) indicate that, to the extent a transfer of money or other consideration by the partnership to a partner occurs after the transfer of property to the partnership, (i) a sale is deemed to have taken place at the time of the original transfer, (ii) the partnership is treated as having transferred to the partner its own obligation to make a subsequent transfer of money or other consideration, to which the installment sales rules of section 453 would apply (unless otherwise inapplicable), and (iii) the principles of section 1274 (and the regulations thereunder) are to be applied in characterizing the subsequent transfer as principal and interest.

There are many questions that arise from treating the transfer as a sale for all purposes of the Code. The sections of the Code listed in Prop. Treas Reg. § 1.707-3(a)(2) deal with the consequences of the deemed sale transaction and only indirectly (at best) with the status of the "contributing partner." For example, if, under the Proposed Regulations, all distributions that the "contributing partner" will receive are to be treated as sales proceeds, does it follow that the "contributing partner" is not an "owner" of a partnership interest for purposes of section 707(b)?[13] We believe that this result, which seems implicit in Prop. Treas Reg. § 1.707-3(a)(3), should be explicitly stated within the context of the "all purposes of the Code" rule. A more difficult question is whether the "contributing partner" is a "member" of the partnership or an owner of an "interest" therein for purposes of the Treas. Reg. § 301.7701-2 characteristics which distinguish partnerships from corporations. In the interests of consistency, we believe this result should follow as well, although we recognize the legitimacy of the contrary view (that Treas. Reg. § 301.7701-2 properly looks to local law characterization, rather than to Federal tax concepts); in any event, the Proposed Regulations should explicitly address these and similar questions (such as the proper classification of a two-member "partnership," one of the partners of which is treated under the Proposed Regulations only as a seller), either in text or by way of example, so that the scope of "all purposes of the Code" will be clear.[14]

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[13] A similar issue may arise under section 871(h)(3)(B)(ii), although it may be unlikely that a purported partnership interest recharacterized as an "obligation" under the Proposed Regulations would meet all the statutory standards for "portfolio debt."

[14] See also section 2701(c)(1)(A)(ii) ("distribution right" for purposes of section 2701 includes right to distributions "with respect to a partner's interest in the partnership").

Regardless of the resolution of these issues of "status," it seems clear from Prop. Treas. Reg. § 1.707-3 (a)(2) that, to the extent disguised sale treatment obtains, both the partner and the partnership are to be treated as having engaged in a sale and purchase. Presumably this will result in gain (or loss) recognition to a partnership that distributes appreciated (or depreciated) property (as opposed to money) to a partner in a transaction that is treated as a disguised sale. Although in Example 2 of Treas. Reg. § 1.707-3(g) the partnership's obligation to make a subsequent transfer involved a transfer of money, there is no apparent reason why the treatment should be any different in the case of an obligation to transfer "other consideration" (such as property). It would be helpful if the final regulations made this clear.[15]

Notwithstanding the apparently clear language of the Proposed Regulations, it is our understanding that at least one former Treasury employee regards an obligation of a partnership to transfer property (other than money) to a partner in a transaction that is treated as a disguised sale as substantively different from a partnership's obligation to transfer money in a similar transaction. We understand that this person believes

[15] In addition, it is not clear under such circumstances whether the selling partner should be allocated any of the gain recognized by the partnership in such transaction. Treas. Reg. § 1.751-l(b)(2)(ii), in the last sentence, and Treas. Reg. § 1.736-l(a)(4), in the penultimate sentence, allocate gains and guaranteed payments respectively to the nondistributee partners only. Although similar in some respects to the allocation issue raised by Treas. Reg. § 1.707-3, we believe it more appropriate to allocate such gain in accordance with fundamental section 704 principles in those transactions treated as sales to the partnership itself. Thus, if the "selling" partner is not bought out completely by the "distribution," gain or loss should be allocable among all the partners, including the "selling partner," in the normal manner. If the "buy-out" is complete, the "selling partner" should have no distributive share of the partnership's gain or loss since the "seller" would be characterized a creditor rather than as a partner.

that the former type of transaction does not involve the transfer by the partnership of an installment obligation that is subject to section 453, but rather involves the transfer of a property right in the nature of a “futures contract” that is ineligible for installment sales treatment by the recipient partner, thus resulting in immediate gain recognition by the partner in an amount equal to the difference between the partner's basis in the transferred property and the current fair market value of the contract right. The Committee does not agree with this view. Where a transfer of property by a partnership to a partner is treated as part of a disguised sale, substantively differing tax treatment is not justified by the form of the consideration which the partnership has committed itself to transfer to the partner. We believe that, at least to the extent that section 1031 does not apply, installment sales treatment (to the extent otherwise available under section 453) should obtain, regardless of whether the subsequent transfer involves cash or other property. In this regard, see Treas. Reg. § 15A.453-1 (c), which governs the treatment of contingent payment sales. Cf. Treas. Reg. § 15A.453-1(c)(5). In any event, to the extent that the Service intends to implement such disparate treatment, the final regulations should so indicate and provide further clarification of this point.

III. DISTRIBUTIONS OF PROCEEDS FROM EXTRAORDINARY SALES OF ASSETS

The Proposed Regulations permit certain distributions of cash flow to partners without running afoul of section 707(a)(2)(B). However, they do not discuss the treatment of distributions of proceeds from extraordinary sales of assets. The final regulations should confirm explicitly that when (1) a partner contributes property to a partnership with the expectation that the partnership will sell the property and (2) the contributing partner will receive a distribution of proceeds from the sale representing some or all of the contributed value, then no disguised sale to the partnership has occurred. More particularly, distributions of proceeds from extraordinary sales of contributed assets should not be treated as a disguised sale under section 707(a)(2)(B) where the property sold, which gave rise to the distribution proceeds, was contributed by the partner receiving the distribution proceeds. In such a case, section 704(c) will allocate any built-in gain on the sale to the contributing partner, without any need for section 707(a)(2)(B) to operate.

Example: A and B form a real estate partnership. A contributes a building worth $100,000 with a basis of $100,000. B contributes two parcels of land, Lot X with a fair market value of $100,000 and a basis of $100,000 and Lot Y with a fair market value of $40,000 and a basis of $20,000. The partnership plans to develop Lot X, but plans to sell Lot Y as soon as a buyer can be found. A and B have agreed to divide equally any book gain and loss from Lot Y. They have also agreed that B will receive the first $40,000 of proceeds from the sale of Lot Y, with the excess split evenly. All other partnership items will be divided 50% to A and 50% to B. The partnership plans to distribute to each partner his share of the sale proceeds from Lot Y shortly after its sale. Assume that the partnership ultimately sells Lot Y for $45,000. B will be allocated $22,500 of taxable gain ($20,000 under section 704(c) and $2,500 under section 704(a) and (b)). A will be allocated $2,500 of gain from the sale (section 704(a) and (b)). The partnership distributes $42,500 to B and $2,500 to A.

The disguised sale rule of section 707(a)(2)(B) was not meant to apply to transactions like that in the above example. Unfortunately, a literal reading of Prop. Treas. Reg. § 1.707-3(b) could lead to the contrary result. Therefore, the final regulations should exempt distributions of proceeds of sales of contributed property from section 707(a)(2)(B). Such transactions should also be exempted from the information reporting requirements of Prop. Treas. Reg. § 1.707-8.

IV. BORROWINGS THROUGH PARTNERSHIPS

We suggest that an additional exemption be created to the disguised sale rules for transactions that are in substance the substitution of collateral for partnership borrowings, to the extent that there is no change in the partner's percentage of economic interest in any property. For example, consider the following situation, which is not unusual in securitization transactions:

> A is in a business that generates zero-basis or low-basis receivables that pay off over a relatively short period, but because of new business A's overall level of receivables remains relatively constant.[16] A wishes to borrow on a nonrecourse basis against the revolving pool of receivables. However, because of bankruptcy concerns lenders are only willing to loan money against the receivables if the receivables are held by a separate entity.

[16] A could, for example, be a cash basis law firm with zero-basis receivables or a dealer in time-shares eligible for installment sale treatment by virtue of section 453(1)(2)(B).

To satisfy the lenders, A transfers receivables to a partnership in which A is a 99% partner in all respects. B, an unrelated partner, transfers cash to the partnership for a 1% interest. The partnership borrows against the receivables and makes a pro rata distribution of the proceeds; A may recognize 1% of the gain on the receivables allocable to the borrowing under section 707(a)(2)(B). When the receivables are collected, A recognizes any remaining gain under section 704(c).

However, when receivables are collected, the lenders permit the cash to be distributed to the partners only to the extent that the cash is replaced with new receivables of equivalent value which A contributes to the partnership. Thus, there is a simultaneous distribution of cash to A and contribution of new receivables to the partnership. Under the Proposed Regulations, it is possible that A must recognize gain on those new receivables because of their contribution together with a simultaneous distribution of cash proceeds from collection of the old receivables.

There is no reason for A to recognize gain on the new receivables in this situation (except possibly as to the 1%), since the transaction is economically equivalent to the substitution of collateral that would occur had A borrowed directly. If such gain recognition is required, A, in effect, loses the benefit of deferral on all receivables transferred to the partnership other than those initially transferred for the proceeds of the cash borrowing. This result is anomalous and places A in a worse position than another borrower with long-term low-basis receivables merely because A's creditors insisted upon A's use of a partnership as a bankruptcy-remote entity. We therefore suggest that the final regulations provide an exception to section 707(a)(2)(B) for transfers by a partner of new collateral to a partnership in exchange for the cash proceeds of old collateral, at least to the extent of the partner's percentage interest in the partnership. This concept of borrowing through a partnership was specifically endorsed in the legislative history of section 707(a)(2)(B).[17] If the exception to section 707(a)(2)(B) is limited in this way, we do not see any potential for abuse.

V. THE FACTS AND CIRCUMSTANCES TEST -- Prop. Treas. Reg. § 1.707-3(b)

The Proposed Regulations provide that a transfer of property by a partner to a partnership followed by a transfer of money or other consideration by the partnership to the partner will be treated as a sale by the partner to the partnership 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.

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[17] H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 862 (1984).

The Facts & Circumstances Test

To the extent that the distribution is made simultaneously with the contribution, the Proposed Regulations give the impression that it will not be subject to such entrepreneurial risk, making the second factor irrelevant in the case of a simultaneous distribution. We note, however, that under local law, partners (including limited partners) who receive distributions may in some circumstances be required to return such distributions to the partnership. In those circumstances in which this is the case, even a distribution simultaneous with a contribution of property may be subject to entrepreneurial risk. Accordingly, while we recognize that the simultaneity of a contribution and distribution may be strong evidence of the absence of entrepreneurial risk, we question the apparent conclusion in the Proposed Regulations that such risk never exists.

In determining whether a sale of property has occurred, the Proposed Regulations place great emphasis on ten factors (the “Ten Factors”) which are “[a]mong the facts and circumstances that may tend to prove the existence of a sale. . . .” The Proposed Regulations further state that “[t]he weight to be given each of the facts and circumstances will depend on the particular case.”

We question whether the facts and circumstances test is effectively implemented by the mere recitation of the Ten Factors. Practical application of the test would be easier if the Ten Factors were listed in some order of priority. In that regard, we concur with the view in the Senate Finance Committee Explanation of the Tax Reform Act of 1984[18] (as well as the General Explanation of the 1984 Act)[19] which assigned more significance to entrepreneurial risk then to other factors in the context of determining whether a putative allocation and distribution to a partner should instead be treated as a disguised payment for services or property.

Moreover, we believe that it should be stated affirmatively that an inference that a disguised sale has not occurred should be permitted to be drawn from the non-existence of one or more of the Ten Factors. In order to avoid turning the ostensibly neutral facts and circumstances test into a “one-way street,” it seems that there should be some positive effect given to the non-existence of any of the Ten Factors, to the extent that any such Factor would otherwise be contextually relevant, taking into account that several of the Factors may overlap to some extent. Alternatively, there should at least be some reference in the body of the regulations (as there is in paragraph (iii) of Example 3 of Prop. Treas. Reg. § 1.707-3(g)) to other factors, the existence of which may tend to disprove the existence of a sale.

In addition to arranging the Ten Factors in a more meaningful fashion, the text of the final regulations should discuss the standard of possibility or probability that must exist as to non-payment of consideration in order to demonstrate

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18 Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, at 227-28 (Comm. Print 1984).

19 Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 227-29 (Comm. Print 1984) [hereinafter 1984 Bluebook].

that the subsequent transfer is dependent on the entrepreneurial risk of partnership operations. The text of Prop. Treas. Reg. § 1.707-3(b) itself does not set forth such a standard. Examples 3 and 5, however, both refer to payments conditional on subsequent events as to which there is a “material risk” or “significant risk” of non-occurrence. To the extent that the use of the term “significant risk” or “material risk” may indicate that a taxpayer must show that it is probable (or more likely than not) that a subsequent payment will not be made, we question the validity of such a standard. Except in the case of a speculative investment, a taxpayer will generally be unwilling to part with his property unless he believes it likely that his investment will be returned with a profit; such an unwillingness is not inconsistent with an “equity” investment. We recommend that the final regulations state explicitly that future payments can be subject to entrepreneurial risk even though the taxpayer expects, or may be legally entitled, to receive them.

Application of Two Year Presumption

Prop. Treas. Reg. § 1.707-3(d) provides that, “if a transfer of money or other consideration to a partner by the partnership and the transfer of property to the partnership by that partner are more than two years apart, the transfers are presumed not to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.” Since taxpayers who desire to have transactions treated as sales, even if payments are to be made more than two years after the transfer of the property to the partnership, will presumably be able to structure their transactions in that form, it seems likely that the presumption of Prop. Treas. Reg. § 1.707-3(d) will most frequently be invoked against the Service. We commend the Service for including this fair provision which will serve in many cases to foreclose fruitless factual disputes between taxpayers and the Service.

It would be helpful, however, if certain aspects of the operation of such a presumption against the Service were clarified. In tax refund and deficiency cases, and in certain other situations,[20] the taxpayer bears the burden of proof[21] and the Commissioner's notice of deficiency is entitled to a “presumption of correctness.” These rules impose on the taxpayer both the burden of going forward with evidence and the ultimate burden of persuasion.[22] We believe that, when the presumption of Prop. Treas. Reg. § 1.707-3(d) operates in favor of the taxpayer, the effect should be to shift both of those burdens to the Service if the taxpayer is able to prove that the transfers in question in fact occurred more than two years apart. Operation of the presumption in this manner would be consistent with the decision of the Tax Court in community Bank v. Commissioner,[23]

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20 E.g., sections 162(c)(1), (2) (illegal payments), 6902(a) (status as transferee), 7454(a) (fraud); Tax Court Rule 142(a) (matters raised in Commissioner's answer).

21 See Welch v. Helvering, 290 U.S. 111 (1933); Tax Court Rule 142(a).

22 For a review of the authorities, see Portillo v. Commissioner, 91-2 U.S.T.C. 50,304 (5th Cir. 1991).

23 62 T.C. 503 (1974), acg. in result, 1975-1 C.B. 1.

in which the court stated that a taxpayer satisfied its burden of proof, including both the burden of going forward and the burden of persuasion, under Treas. Reg. § 1.166-6(b) regarding the fair market value of property acquired at foreclosure simply by proving the amount it had bid for the property, since Treas. Reg. § 1.166- 6(b)(2) provided that such bid is presumed to be fair market value in the absence of clear and convincing evidence.[24]

The Community Bank case also suggests a further improvement to the presumption in the Proposed Regulations. Although, as stated above, we believe that operation of the presumption shifts the burden of going forward and the burden of persuasion to the Service, we do not believe that it is clear what standard of proof the Service must meet. Treas. Reg. § 1.166-6(b)(2) provides that the presumption that bid price and value are equal must be rebutted by "clear and convincing evidence," a standard also used by the Tax Court in civil fraud cases.[25] By contrast, Prop. Treas. Reg. § 1.707-3(d) uses the formulation, "the facts and circumstances clearly establish." There does not appear to be any reason to create a new intermediate standard of proof between the usual "preponderance of the evidence" and "clear and convincing evidence," and we recommend that the "clear and convincing evidence" standard, with which courts are already familiar, be adopted for this purpose.

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[24] Compare Fed. R. Evid. 301 (except as otherwise "provided for by Act of Congress," presumptions do not shift burden of persuasion); section 183(d) (presumption that may be rebutted simply by the Secretary's "establish[ing] to the contrary" which has been held not to shift the burden of persuasion). The use of the words "clearly establish" in Prop. Treas. Reg. § 1.707-3 should work an exception to the general principle of Rule 301.

[25] See Tax Court Rule 142 (b). This standard is also used by courts in a variety of nontax contexts. See Graham, Handbook of Federal Evidence § 301.5 (3d ed. 1991).

Specific comments Relating to "Mixing Bowl" Transactions

Example 8 of Prop. Treas. Reg. § 1.707-3(g), which is obviously intended to be illustrative of the facts and circumstances analysis, is helpful in some ways but leaves many questions unanswered.[26] Accordingly, our comments in this section, although focused on Example 8, also have broader application to the facts and circumstances test in general.

In particular, it is disappointing that Example 8 does not really provide any meaningful guidance, since it assumes the existence of at least three or four of the Ten Factors, without indicating whether any one of such Factors would, by itself, prove the existence of a sale. In addition, Example 8 contains a factual ambiguity which muddies its analysis further, since it is not clear from the Example whether the fact that the partners "contemplated" that the government securities would be transferred after two years to the partner who contributed appreciated property means that the partnership agreement requires that the subsequent transfer be made (and, if so, when such transfer would take place), or means merely that the partners have a tacit (and presumably unenforceable) "understanding" that such a transfer is likely to take place.[27]

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[26] It is also the only guidance provided by the Proposed Regulations regarding so-called "mixing bowl" transactions.

[27] Another fact pattern could involve an agreement whereby the noncontributing partners had the right (but not the obligation) to cause the partnership to redeem the property contributing partner's interest by distribution of the securities, cash, some other asset, or a proportionate interest in each asset.

Assuming that the partnership agreement requires the subsequent transfer, by virtue of the nature of the partnership's interest rate sensitive properties (i.e., government securities and net leased real estate), Factor (1) of the Ten Factors appears satisfied since the "timing and amount of a subsequent transfer are determinable with reasonable certainty." Factor (2) (relating to whether the partner has a legally enforceable right to the subsequent transfer) is obviously satisfied as well. In addition, Factor (7), which deals with whether the partnership holds cash or "other liquid assets" beyond the reasonable needs of the business, is also implicated by the facts of the Example. Finally, in view of the manner in which the income from both the office building and the government securities is allocated among the partners, Factor (8) (relating to whether the partnership distributions and allocations and control of partnership operations are "designed to effect an exchange of the benefits and burdens of ownership of property") also seems to be inapplicable in Example 8.

We are troubled by the fact that it is not clear whether it is only the cumulative effect of the Factors that are implicated in Example 8 that leads to the conclusion that a disguised sale has in fact taken place. For example, would the result in Example 8 be different if the value of, and income from, either of the partnership's assets could fluctuate materially prior to the "contemplated" distribution.[28] We believe that factor should make a difference. Is the fact that the

[28] Compare Allison v. Commissioner. 35 T.C.M. (CCH) 1069 (1976).

property contributing partner has a legally enforceable right to the subsequent transfer, together with the disproportionate allocations, sufficient to prove the existence of a sale? If he did not have such a right, we believe that should be very relevant in determining whether there has been a disguised sale, since the essence of being a seller is the legal right to be paid the selling price in the future.

Alternatively, assuming that the partnership is <u>not</u> legally required to make the subsequent transfer, since the allocation scheme seems clearly designed to “effect an exchange of the burdens and benefits of ownership of [the office building],” Factor (8) is obviously still implicated. Will that factor, by itself, be sufficient to trigger disguised sale treatment to the property contributing partner? Absent that factor, we do not believe that application of the disguised sale rule is proper, merely because the value of the partnership's asset may not be volatile. In fact, we believe that a sale or exchange between a partner or a partnership under section 707(a)(2) should not be treated as occurring just because the “partnership distributions, allocations or control of partnership operations is designed to effect an exchange of burdens and benefits of ownership of property.” The contribution of property to a partnership <u>always</u> effects an exchange of benefits and burdens of ownership of property, even though it may be tax-free to the contributing partner under section 721. This is generally true irrespective of the level of interest in such property retained indirectly by the contributing partner through his partnership interest or the volatility of its income or value.

Accordingly, this factor should only be relevant when used in conjunction with other factors listed in Prop. Treas. Reg. § 1.707- 3(b)(2) to indicate a sale of property between a partner and a partnership.

The Committee suggests that the analytical value of Example 8 could be enhanced substantially if the fact pattern presented therein were broken into several examples, with varying factual assumptions intended to illustrate the significance of the various Factors which may indicate the existence of a sale, much in the way that Examples 5, 6, and 7 illustrate the principle of entrepreneurial risk by imposing certain key variations on an underlying common fact pattern.

We also believe the final regulations would be significantly improved if an additional example or examples illustrated several key points not made clear in the Proposed Regulations. One such point would be that the mere “anticipation” of a partnership liquidation in kind would not trigger disguised sale treatment absent other substantial factors implicating section 707(a)(2)(B). Many partnerships are organized to make use of specific assets, or to conduct a specific business for a finite period of time, followed by a negotiated distribution of the assets in kind. The mere fact that (1) subchapter K permits this to be done in a deferred way and (2) that the partners realize that tax benefit upon formation of the partnership, does not justify imposing disguised sale treatment. We also believe that the presence of bona fide non-tax business reasons for using a partnership (rather than a traditional installment sale or deferred exchange) also should be a relevant factor in establishing that the "substance" of the transaction, as well as its form, is a partnership (rather than an installment sale or deferred exchange). Case law is clear that a valid nontax business purpose for the form of a transaction supports consistent treatment for tax purposes. Cf. Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Newman v. Commissioner, 902 F.2d 165 (2d Cir. 1990). The final regulations should be consistent with such case law.

> Example: X operates various businesses throughout the U.S. One of its businesses (the A Business) has a value in excess of its tax basis. X has made a strategic decision to reduce its activities in Area A and expand its activities in Area B.
>
> Y—1 and Y-2 want to acquire the A Business. But X does not want to sell it immediately. X, Y-l and Y-2 form a partnership. X contributes the A Business. Y-l and Y-2 contribute cash. The cash is used to buy a similar business in Area B (the B Business). The economic attributes of both businesses are similar (i.e., their profit potential and earnings volatility). But they are hot like kind. Assume there are tax and business advantages and disadvantages to the partners by virtue of their partnership structure as compared to owning and operating the two businesses separately.
>
> Upon formation of the partnership the partners anticipate that it will be liquidated after several years because it is likely to be in their business interests to do so. But there is no binding agreement to that effect. Upon a liquidation, the partnership agreement requires a sale of all

assets for cash unless the partners agree otherwise. Given X's current business plan, in a liquidation X anticipates negotiating to receive the B Business. Y-l and Y-2 expect to negotiate to receive the A Business. But the partners' current intent may change. Upon any liquidation, the partnership will book up (or down) its assets. Liquidating distributions will follow the partners' book capital accounts as adjusted.

Assume that in 1994 the partners will agree that X will withdraw from the partnership. For tax and business reasons the B Business will be distributed to X (together with cash to zero out X's remaining capital account). Y-l and Y-2 will continue to operate the A Business as partners. All allocations and distributions prior to X's withdrawal were proportionate to the partners' capital.

In this type of pattern, we do not believe it appropriate to apply section 707(a)(2)(B) to X absent other factors clearly evidencing a disguised exchange of the A Business for the B Business.

VI. SPECIAL RULES RELATING TO LIABILITIES -- PROP. TREAS. REG. § 1.707-5

Treatment of Nonrecourse Debt Generally

The Proposed Regulations characterize proceeds from nonqualified non-recourse debt as proceeds of a disguised sale based upon the contributing partners smallest share of future profits from the property contributed. An exception is provided permitting the partnerships to designate a different percentage if that percentage is based upon the partner's "predominate share" of partnership profits from the contributed property. The stated justification for not relying upon the allocation method in Treas. Reg. § 1.752-1T (e) is that it leads to anomalous results, decreasing a contributing partner's recognized gain when the built-in gain in the contributed property increases. We agree that would be an anomalous result. But we do not believe an anomalous result justifies the alternative in the Proposed Regulations using the "smallest share" of future profits. Use of that alternative would cause all of a nonqualified nonrecourse debt to be sale proceeds in many cases unless the partner could establish a higher "predominant percentage." However, that exception to the general rule, as written, is unclear and difficult to apply.[29] See Nonrecourse Debt Allocations, infra. We recommend that the final regulations allow partnerships the same flexibility in allocating nonrecourse debt for purposes of section 707(a)(2)(B) as for section 752. In particular, a partnership should be able to select a profit allocation percentage consistent with its allocation of excess nonrecourse debt under section 752. See Treas. Reg. § 1.752-1T (e)(3)(ii)(C). We strongly believe that this middle-ground position, between the extremes of a complete exemption for nonrecourse debt on the one hand and use of the smallest profit percentage on the other hand, is fair and appropriate and provides the flexibility necessary to accommodate typical partnership agreements having shifting profit allocations.

[29] Many partners contributing property encumbered by nonqualified nonrecourse debt will be taxed in full under the Proposed Regulations. That is because many partnership agreements provide priority profit allocations to other partners at some point in time or until some predetermined profit or yield has been allocated to those partners. In such cases, the property-contributing partner's smallest profit share will be zero.

Nonrecourse Debt/Fair Market Value Issues

The Proposed Regulations provide that a liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership will not be treated as a qualified liability to the extent the amount of such liability exceeds the fair market value of the transferred property at the time of the transfer (an "Excess Liability").[30] This rule makes sense in the context of recourse indebtedness, where the partnership's assumption of such partner's Excess Liability is tantamount to a distribution of equity value to such partner, not a contribution of equity value by the partner. Such a rule is not appropriate, however, in the context of nonrecourse debt, where the contributing partner never did bear personal liability for the debt, and is therefore not being meaningfully relieved of indebtedness when property subject to such debt is contributed to a partnership.[31] In this context, the fair market value of the transferred property should not have a bearing on the extent to which the partnership's assumption of an Excess Liability

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30 The use of the phrase "to the extent" in the definition of "qualified liability" could create a trap for the unwary. Under Prop. Treas. Reg. § 1.707-5(a)(5)(i), the favorable miles for qualified liabilities are, in effect, applied only in cases in which no other consideration is deemed to be sales proceeds under the Proposed Regulations. For example, if property with a value of $99, but subject to an otherwise qualified nonrecourse debt of $100, is contributed to a partnership, it is true that only $1 of the debt is not a qualified liability. However, the effect of treating part or all of that $1 as sales proceeds (which seems inevitable under the Proposed Regulations) is to cause part or all of the $99 qualified liability to be treated as sales proceeds as well. See Prop. Treas. Reg. § 1.707-5(a)(5)(i).

31 The contributing partner's tax liability will not be avoided in this case, since the full excess of the liability over the property's basis ultimately will be allocated as gain to the contributing partner (or reduced depreciation deductions) under section 704(c).

indicates the existence of a sale. Accordingly, the final regulations should make clear the distinction between recourse and nonrecourse indebtedness in this context, perhaps by specifically incorporating the principles of section 7701(g), which provides that the fair market value of property shall be treated as not less than the amount of any nonrecourse debt to which it is subject.[32] See also Treas. Reg. § 1.1001-2.

Nonrecourse Debt Allocations - The Alternative Method

Prop. Treas. Reg. § 1.707-5(a)(2)(iii) provides that a partner's share of nonrecourse liabilities encumbering property contributed to a partnership is generally equal to the contributing partner's smallest percentage interest in any material item of partnership income or gain from the property securing the nonrecourse liability. The Proposed Regulations, however, permit the partners to disregard the smallest percentage and to use a higher percentage for this purpose if:

> it is reasonably expected that more of the net income (including gain) from the encumbered property will be realized by the partnership and allocated while this allocation percentage is in effect, than while any other allocation percentage provided in the partnership agreement is in effect.

32 As proposed, this rule would not alter fundamental tax concepts used to determine if nonrecourse debt is bona fide for tax purposes. Cf. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). If the debt was bona fide when incurred by the contributing partner under fundamental tax concepts, it should be treated as debt for purposes of section 707(a)(2)(B), even if the value of the property collateralizing the nonrecourse debt declined in value between the time the debt was incurred and the time the property was contributed to the partnership. Cf. Treas. Reg. § 1.1001-2.

It is not clear from this language how the alternative method of determining profit or gain percentages is to work. Partnerships may shift profit and gain ratios using various criteria. Many partnerships provide for a shift after a certain amount of income and gain has been realized. Other partnerships, however, shift profit and gain ratios after a predetermined period of time has elapsed, without regard to the amount of profit or gain actually realized prior to the shift. The final regulations should make clear how the alternative rule operates in each of these situations.

Refinancings

1. General Comments. Under the Proposed Regulations, a liability encumbering property contributed by a partner to a partnership will be considered a "qualified liability" (and the partnership's assumption of such liability will therefore not be treated as a transfer of sales consideration by the partnership to the partner) if such liability was incurred more than two years prior to the contribution or if other tests relating to the use of the debt proceeds are met. When a qualified liability is refinanced, the Proposed Regulations draw an unwarranted distinction between situations in which the liability is refinanced prior to, and those in which it is refinanced after, the contribution of the property.

Under Prop. Treas. Reg. § 1.707-5(c), if, after contribution to a partnership of property encumbered by a qualified liability, the partnership refinances such qualified liability, the refinancing indebtedness (the "New Debt") will be treated as the refinanced indebtedness (the "Old Debt"), and will therefore preserve the benefits of qualified liability status for purposes of the disguised sale rules. By contrast, no such "tacking" rule exists with respect to debt that is refinanced by a partner prior to its transfer to a partnership. Thus, if a partner refinances Old Debt that is otherwise considered a qualified liability by reason of its having been incurred more than two years prior to a contribution (or by reason of having been incurred, within two years, for purposes of acquiring the property), the liability's status as "qualified" appears to be lost upon the refinancing, and the partnership's assumption of the New Debt will be presumed to be a transfer of consideration from the partnership to the partner, pursuant to a sale of the encumbered property. Since the Old Debt must have been secured by the transferred property or must have been acquisition debt traceable to that property, New Debt which merely replaces such qualified debt does not afford any opportunity for abuse.

Frequently, it is necessary as a business matter to refinance indebtedness that a lender is unwilling to have assumed by a partnership, even for a brief period of time. As a practical matter, the lack of symmetry between partner-refinanced debt and debt refinanced by the partnership presents a significant obstacle to legitimate refinancing transactions that often precede contributions of property to a partnership.

We suggest that the final regulations contain a rule (analogous to Prop. Treas. Reg. § 1.707-5(c)) stating that, to the extent a partner has incurred New Debt the proceeds of which are allocable under the rules of Temp. Treas. Reg. § 1.163-8T to payments discharging Old Debt, such New Debt is to be treated as the Old Debt for purposes of determining whether such New Debt is a qualified liability. Since the Old Debt must have been secured by the transferred property or must have been acquisition debt traceable to that property, New Debt which merely replaces such qualified debt does not afford any opportunity for abuse.

2. Treatment of Consolidated Groups and Corporate Reorganizations. In the context of a consolidated group of corporations (which is treated for at least some other tax purposes as, in effect, a single corporate taxpayer), a subsidiary's refinancing of its parent's qualified liability prior to contribution of assets should be entitled to the same “tacking” treatment as discussed above. It should not subject the subsidiary to the negative 2-year presumption contained in Prop. Treas. Reg. § 1.707-5(a)(7). This is particularly so when the parent's liability was originally secured by a pledge of the subsidiary's stock and/or a guarantee of the parent's debt by the subsidiary. Accordingly, we suggest that, for this purpose, the disguised sale rules be applied on a consolidated group basis. Similarly, for purposes of “tacking,” a predecessor and its successor in a section 381 transaction should be treated as a single taxpayer.

“Ordinary Course” Liabilities

Prop. Treas. Reg. § 1.707-5(a)(6)(i)(D) includes within the definition of qualified liability a liability that was “incurred in the ordinary course of the trade or business in which the property transferred to the partnership was used or held but only if substantially all of the assets used or held in such activity are transferred to the partnership.” This definition gives rise to a number of interpretive problems.

It is not entirely clear how the term "trade or business" is to be interpreted. For example, how would a taxpayer be treated who transferred property (encumbered by debt) used in an activity that did not meet the "trade or business" test for purposes of section 162? Clearly, there is no policy reason to deny "qualified liability" status in such a case. The Committee recommends that Prop. Treas. Reg. § 1.707-5(a)(6)(i)(D) be expanded to include any liability "incurred in the ordinary course of a trade or business or other activity engaged in for profit (including research and experimentation) in which the property transferred to the partnership was used or held, but only if substantially all of the assets used or held in such trade or business or activity are transferred to the partnership."[33]

"Holdback" Issues

Accounts payable and similar liabilities incurred in the ordinary course of business are treated as qualified liabilities only if substantially all of the assets of the business are "transferred" to the partnership. A similar rule is contained in the "mere change in form" exception from investment tax credit recapture of Treas. Reg. § 1.47-3(f). Cases under Treas. Reg. § 1.47-3(f) treat a transfer of a going business to a partnership as a mere change in form even if tax ownership of substantially all the assets is not transferred to the partnership, so long

[33] Compare section 469(c)(5); Treas. Reg. §§ 1.469-1T(e)(2)(ii), 1.469-4T(b)(2)(ii)(A)(3) ("trade or business" for purposes of section 469 includes research or experimentation not otherwise meeting section 162 standards); section 469(c)(6) (authority to include other activities engaged in for profit in "trade or business" definition).

as the necessary assets which are not transferred are leased or licensed to the partnership.[34] The Committee believes that a similar rule should apply for purposes of Prop. Treas. Reg. § 1.707-5(a)(b)(i)(D), since the spirit of that provision seems to be that a transfer and continuation of the same business which constitutes a mere change in the form of doing business should not be inhibited by adverse tax consequences. Similarly, when one partner transfers a going business which has substantial accounts receivable, often the other partners insist that the contributing partner retain the accounts receivable, rather than assigning them to the partnership. The other partners do so for a number of sound business reasons (i.e., to put the burden of noncollection on the contributing partner, to avoid disputes as to valuation, reserves, and time of collection, etc.). A typical holdback of accounts receivable in such a transaction should not cause accounts payable and other trade or business liabilities no longer to constitute qualified labilities under Prop. Treas. Reg. § 1.707-5(a)(6)(i)(D).

Maturing Liabilities

The legislative history of section 707(a)(2)(B) discussed the possibility that a transfer of an "old and cold" liability to a partnership might constitute disguised sale proceeds if the transferred liability was coming due.[35] The Proposed Regulations do not seem to distinguish qualified and nonqualified liabilities based upon the due date of the liability or upon the fact that there might be an immediate payoff of the liability by the partnership with capital contributed by other

[34] See Loewen v. Commissioner, 76 T.C. 90 (1981), acg., 1983-2 C.B. 1.

[35] See 1984 Bluebook, supra note 19, at 231-33.

partners. We believe those conclusions are appropriate. However, the Service should confirm in the preamble or by an example that the due date of a qualified liability (or its immediate payoff) is not relevant under section 707(a)(2)(B).

“Tainting” of Qualified Liabilities

Prop. Treas. Reg. § 1.707-5(a)(5) provides a special rule applicable to transfers of property encumbered by qualified liabilities, whereby a partnership's assumption of or taking subject to such liability will be treated in part as a transfer of consideration by the partnership to the partner pursuant to a sale, if the partner's transfer of property to the partnership is otherwise treated as a sale, without regard to the debt assumption. In other words, a partnership's transfer of consideration to a partner that is considered indicative of a sale of property by the partner may “taint” the partnership's assumption of an otherwise qualified liability and result in a deemed transfer of additional sales consideration to the partner.

> Example: A and B form Partnership AB, a general partnership. A contributes Property A, with a basis of $0 and a fair market value of $100, encumbered by a qualified liability of $90, and B contributes Property B with a basis of $0 and a fair market value of $150, encumbered by a qualified liability of $100. A and B wish to operate the Partnership on a 50/50 basis. In order to “equalize” the partners' respective capital accounts, upon formation of the Partnership they intend to cause the Partnership to borrow $40 against Property B (on a nonrecourse basis) and to distribute the borrowed proceeds to B, leaving each partner with $10 of net equity in the Partnership.

Under Prop. Treas. Reg. § 1.707-5(b), the distribution of $40 of borrowed proceeds to B would be considered a transfer of sales consideration to B of $20 (A's allocable share of the $40 total nonrecourse liability). Since B is treated as having received sales consideration without regard to the partnership's assumption of the $100 qualified liability, a portion of the qualified liability will be "tainted" and treated as the receipt by B of additional sales consideration. Such portion is calculated by reference to B's "net equity percentage" in the transferred property ($20/$50, or 40%) multiplied by the amount of the qualified liability ($100). Accordingly, B is treated as having received total sales consideration of $60 ($20 plus $40) as a result of this rule.

While that result is consistent with the treatment of transfers of undivided interests in property subject to debt, this result may be contrary to the policy rationale underlying the beneficial treatment afforded to qualified liabilities (i.e., debt that is sufficiently "old and cold" is deemed not to have been incurred in anticipation of the transfer of property to the partnership). Moreover, partners will frequently agree to cause a partnership to distribute post contribution borrowing proceeds as an "equalization" payment, in order to establish the partners' desired capital and profit ratios on a going-forward basis.[36]

[36] Compare Jacobson v. Commissioner, 96 T.C. No. 21 (1991) (distinguishing under pre-section 707 (a)(2) law between "usual and customary" arrangements whereby a partner who puts up a greater share of capital than his share of the profits receives preferential distributions to equalize capital accounts, which arrangements would not give rise to a finding that a disguised sale had taken place, and arrangements in which the amount of cash transferred by one partner was computed by determining how much cash would be needed to equalize capital accounts and ownership percentage interests, which arrangements did give rise to a finding that a disguised sale had occurred).

In that context in particular, the tainting rule can produce harsh results. Indeed, the partner receiving the equalization payment may be required to recognize less gain than in a transaction in which qualified liabilities are not involved and in which a greater amount of equity is being "extracted" from the property.[37]

> Example: Assume the same facts as in the prior Example, except that neither property is encumbered by any debt at the time it is contributed to the Partnership. The Partnership borrows $90 against Property A and borrows $140 against Property B and immediately distributes $90 to A and $140 to B.

Under Prop. Treas. Reg. § 1.707-5(b)(2)(ii), the transfer of cash to each of A and B would be treated as a transfer of sales consideration only to the extent that the amount of money received by each partner exceeds such partner's allocable share of the liability funding such distribution. Since the Proposed Regulations require both liabilities to be treated as one liability for this purpose and since each of A's and B's sharing percentage is 50% at all times, each of A's and B's allocable share of the aggregate $230 liability equals $115. B is treated as having received only $25 of consideration (the excess of $140 over $115).

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[37] Note that the succeeding section of this report recommends that a partner contributing property subject to a qualified liability be permitted to "net" the liability from which he is being relieved against both nonqualified liabilities and other qualified liabilities.

The Committee believes that the tainting rule contained in Prop. Treas. Reg. § 1.707-5(a)(5) may lead to results that are unfair and will produce a trap for the unwary. We recommend that the final regulations[38] consider providing an exception, at the least, for de minimis transfers of cash or other consideration, so that unsuspecting taxpayers, relying on the old-fashioned belief that contributions of property to partnerships may generally be made on a tax-free basis, may be protected against the sometimes draconian result inherent in the current version of the Proposed Regulations. If such a de minimis rule is included in the final regulations, appropriate adjustments must be made in computing the amount of basis in the property allocable to the portion deemed sold. The proper method for such allocation would be to determine the percentage of the gross fair market value of the property transferred that is considered sold (unreduced by qualified liabilities) and to apply that percentage to the transferor's tax basis in the property.

Netting of Liabilities

Prop. Treas. Reg. § 1.707-5(a)(4) provides a special "netting" rule with respect to transfers of encumbered properties to a partnership by more than one partner pursuant to a plan. Under this special rule, if the partnership assumes or takes properties subject to nonqualified liabilities of more than one partner pursuant to a plan, each partner's share of the

[38] Regardless of their treatment of the "netting" issue. See Netting of Liabilities, infra.

nonqualified liabilities assumed or taken subject to by the partnership pursuant to that plan immediately after the transfers equals the sum of the partner's shares of the respective liabilities assumed or taken subject to pursuant to the plan. Thus, each partner is permitted to offset his nonqualified liability against other nonqualified liabilities assumed or taken subject to by the partnership pursuant to a plan, in order to determine the net extent to which such partner is being relieved of liabilities in excess of his allocable share of the partnership's <u>total</u> liabilities immediately after the transfer of the encumbered property to the partnership.

> <u>Example</u>: C and D form an equal general partnership, CD, with C contributing Property C, worth $100, and D contributing Property D, also worth $100. Immediately prior to the contribution of their respective properties, however, each of C and D borrows $90 against his property and, pursuant to a plan, the Partnership assumes the $90 liability encumbering each property.

Under Prop. Treas. Reg. § 1.707-5(a)(1), because C and D are each contributing property subject to a nonqualified liability, each of C and D is treated as having received consideration to the extent that the amount of the liability ($90) exceeds such partner's allocable share of such liability immediately after the contribution ($45).

Under the aggregation rule contained in Prop. Treas. Reg. § 1.707-5(a)(4), however, each partner's share of partnership liabilities equals the sum of his shares of each nonqualified liability assumed pursuant to the plan. Thus, each of C and D has a share of the $180 of total liabilities equal to $90 ($45 plus $45) and neither partner is treated as having received any consideration pursuant to a sale.

As noted above, however, the aggregation rule applies only to nonqualified liabilities. Accordingly, a partner contributing property encumbered by a nonqualified liability will not be permitted to aggregate such liability with another partner's qualified liability assumed by the partnership, even if both liabilities are assumed pursuant to a plan.

> Example: Assume the same facts as in the prior Example, except that the $90 liability encumbering Property D is a qualified liability (because it was incurred by D more than two years prior to the contribution).

Under these circumstances, C will not be permitted to aggregate the liabilities encumbering both Property C and Property D in determining his allocable share of the partnership's total liabilities immediately after the contribution. Thus, the excess of C's nonqualified liability ($90) over C's share of that liability immediately following the contribution of Property C ($45) will be treated as having been received by C pursuant to a sale of Property C.

We do not understand why nonqualified liabilities are treated differently from qualified liabilities in this context. The difference is particularly hard to justify where the economic consequences to the partners are exactly the same, as in the two previous Examples.[39] Accordingly, we urge that the final

[39] It is especially anomalous for C to suffer because D's liability is qualified.

regulations be amended to expand the netting rule so that it applies to all liabilities assumed or taken subject to by the partnership, whether qualified or nonqualified.

VII. <u>OTHER RECOMMENDATIONS</u>

<u>Safe Harbor Distributions</u>

1. <u>Guaranteed Payments</u>. “Plain vanilla” guaranteed payments to a partner contributing appreciated property do not run afoul of the disguised sale rules. Prop. Treas. Reg. § 1.704-4(a). However, certain “sinister” types of guaranteed payments may be treated as disguised sales. Example 2 of Prop. Treas. Reg. § 1.707- 4(a)(4) involves such a transaction. There are several factors that are somewhat unusual in that Example, including (i) disproportionate capital contributions, (ii) funding of the guaranteed payments out of cash flow otherwise distributable to the noncontributing partner, and (iii) the fact that the guaranteed payments only last for a limited period of time. The Service should make clear which of these factors was most determinative in reaching the conclusion in the Example and whether the result would be different if any one of these factors had been lacking.[40]

[40] It is our view that a perpetual guaranteed payment (within the guideline percentage) should never be considered to be sale proceeds because it would represent earnings on, and not an implicit return of, capital.

2. Operating Cash Flow Distributions

a. The General Rule. The Proposed Regulations provide that, notwithstanding the presumption contained in Prop. Treas. Reg. § 1.707-3(c) (regarding transfers made within two years of each other), an operating cash flow distribution is presumed not to be part of a sale of property to a partnership, unless the facts and circumstances clearly establish that such distribution is part of a sale. We suggest that the Proposed Regulations contain an example that would make this aspect of the presumption clear.

> Example: A and B are partners in AB Partnership. A contributes property X to AB, and B contributes cash to AB. A and B are allocated 90% and 10%, respectively, of profits and operating cash flow for the first four years, and thereafter, A and B are allocated 60% and 40%, respectively, of profits and operating cash flow.

A is not treated as receiving a “payment” under Prop. Treas. Reg. § 1.707-3(c) within two years of the transfer of A's property pursuant to Prop. Treas. Reg. S 1.707-4(b)(2)(ii). A receives only operating cash flow payments from AB. Although such payments may exceed A's smallest interest in the overall partnership profits for the life of the partnership (i.e., 60%), such payments during the first two years do not exceed 90%, which is A's lowest percentage determined under the safe harbor test, which permits looking only to years 1-3 for purposes of testing the year 1 payment and to years 2-4 for purposes of testing the year 2 payment. In years 3 and 4, the payments will fail the safe harbor test, but will be presumed under the general rule for operating cash flow distributions not to be in exchange for property X, unless the facts reflect otherwise.[41]

b. Difficulties with the Definition of Net Cash Flow. We question the definition of net cash flow under Prop. Treas. Reg. § 1.707-4(b)(2), which starts with taxable income and then generally increases such amount for non-cash deductible items and decreases such amount for non-deductible cash expenditures. Because many partnerships are required to use the accrual method of accounting, taxable income may reflect the accrual of income that has been earned but not yet received and expenses that have been incurred but not yet been paid. Under the formulation of the Proposed Regulations, net cash flow may represent accrued net income, not net cash flow. Net cash flow as used in most partnership agreements is a cash receipt and expenditure definition; net cash flow is generally the excess of cash receipts from operations over cash expenditures. (Generally, the cash expenditures included are the items that give rise to a current expense plus the non-deductible expenditures set forth in (A) through (D) of Prop. Treas. Reg. § 1.707-4(b)(2). Cash receipts included are generally current operating revenue plus sale and refinancing proceeds.) Thus, taxpayers that have significant amounts of accrued income will have more net cash flow than under a cash receipt and expenditure definition. On the other hand, taxpayers that have significant amounts of accrued

[41] Additionally, in this Example, the basic two-year presumption of Prop. Treas. Reg. § 1.707-3(d) may apply.

expenses will have less net cash flow than under a cash receipt and expenditure definition. Although we speculate that the Service may think that there may be administrative convenience in starting with taxable income (a number identified on each partnership information return), we do not think that such administrative convenience reason is sufficient to justify the current definition. Therefore, we recommend that the final regulations adopt a cash receipts and expenditures definition in which, in line with the present purpose of the operating cash flow distribution rule, the items of cash receipts and expenditures should take into account only operating revenues and expenditures. As discussed previously, a separate rule should provide for the distribution of proceeds from sales of contributed property in transactions to which section 704(c) would apply.

c. Difficulties with the Operating Cash Flow Distributions Rule. If the Service does not change the definition of net cash flow as discussed above, we have some comments on the current formulation of net cash flow under the Proposed Regulations.

Prop. Treas. Reg. § 1.707-4(b)(2) requires that, in determining a partnership's net cash flow, the partnership's taxable income be reduced by certain payments made by the partnership, including payments of debt principal, certain reserves, capital expenditures, and other nondeductible cash expenditures. Presumably, such negative adjustments are intended to reflect instances in which the partnership has devoted its cash resources to expenditures that would not be deducted in arriving at taxable income. These negative adjustments to operating cash flow should accordingly reflect only expenses which are funded with cash flow which is included in the basic definition of operating cash flow. Thus, the negative adjustments should generally exclude expenses funded from sources of cash flow excluded from the definition of operating cash flow e.g., debt proceeds and proceeds of a capital transaction (including any gain arising out of the ordinary course of business)).

d. Other Comments Concerning Operating Cash Flow Distributions. First, we believe that the final regulations should confirm that the presumption regarding operating cash flow distributions would not be rebutted simply because a partnership is engaged in a purportedly low-risk business such as net leasing real estate or equipment.

Second, under Prop. Treas. Reg. § 1.707-4(b)(2) the amount of net cash flow that is presumed to be a distribution to a partner in his capacity as a partner is an amount distributed by the partnership to the partner up to the partnership's net cash flow, as described above, multiplied by the lesser of the partner's percentage interest in “overall partnership profits” for that year and the partner's percentage interest in “overall partnership profits” for the life of the partnership. The term “overall partnership profits” is unclear. The Proposed Regulations do not define the term, and the term is not defined in the Code. Prop. Treas. Reg. § 1.707-4(b)(2) by its choice of words seems to imply that partnership profits for this purpose means economic profits, reflecting the same concepts as operating cash flow as opposed to taxable income. But a partner's percentage interest in overall profits would also include a partner's interest in gain on sale of the partnership's property which, based on the purpose of the operating cash flow distribution rule, should be excluded from the term “overall partnership profits.” The final regulations should clarify the term “overall partnership profits.”

Multiple Property Transfers

Prop. Treas. Reg. § 1.707-3(e) provides that if a partner transfers multiple properties to a partnership pursuant to a plan, the total consideration that is treated as received by the partner from the partnership as part of a sale transaction is to be allocated among each item of property transferred pursuant to the plan, based on the properties' relative fair market values. Thus, under this rule, a partner will not be permitted to treat certain transfers of property to a partnership as contributions under section 721, while treating other property transfers as sales, if all such transfers take place pursuant to a plan. Presumably, this rule was inserted into the Proposed Regulations to preclude partners from utilizing in the tax planning technique of selling high-basis properties to a partnership while transferring low-basis assets in the form of a contribution subject to section 721. This provision raises several policy issues. First, there is nothing in the legislative history to the 1984 Act or in section 707(a)(2) to suggest that Congress intended to change whatever the existing treatment for multiple property transfers by sale and contribution may be. Second, although the Service has the authority to promulgate such a rule, that does not mean the rule is necessarily appropriate for all multiple property transfers to partnerships. That is particularly the case where there are sound nontax business reasons for the designated consideration transferred to the partner for each asset. For example, suppose that a partnership agrees to accept a contribution of business assets in exchange for a partnership interest on some future date, but because the transferor and partnership have separate credit lines to finance receivables and inventory, and the amounts of receivables and inventory fluctuate considerably, the partnership agrees to pay' cash to buy any receivables and inventory it receives. It seems odd to have the amount of gain or loss recognized with respect to other assets depend on the levels of receivables and inventory at the time of the transfer. Third, the proposed rule differs from the rule that applies to contributions and sales of property to corporations by shareholders, where at least in some sales situations sales have been recognized.[42] We believe the rules on multiple property transfers should be consistent for all taxpayers, whether they choose to do business as partners in a partnership or as shareholders in a corporation.

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[42] See Curry v. Commissioner, 43 T.C. 667 (1965); Morgan v. Commissioner, 30 T.C. 881 (1958), acq. in part, 1959-1 C.B. 4; Brown v. Commissioner, 27 T.C. 27 (1956), acq., 1957-2 C.B 4. Compare D'Angelo v. Commissioner, 70 T.C. 121 (1978); Adams v. Commissioner, 58 T.C. 41 (1972); Nye v. Commissioner, 50 T.C. 203 (1968).