Recommendations to Simplify Treas. Reg. § 1.731-1(c)(3)

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Partnerships Committee of the Section of Taxation. Principal responsibility was exercised by John Gadon. Substantive contributions were made by Robert R. Casey and Sherwin Kamin. The Comments were reviewed by John P. Barrie, of the Committee on Government Submission of the Section of Taxation, and by Stanley L. Blend, Supervisory Council Director.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: May 31, 2002
# TABLE OF CONTENTS

I. Executive Summary .......................................................................................................................... 3

II. Paragraph (c)(3) of Treas. Reg. § 1.731-1 .................................................................................. 3
   A. Introduction ............................................................................................................................... 3
   B. Cross References .................................................................................................................... 4
   C. Interpretation .......................................................................................................................... 5

III. Section 707(a)(2)(B) .................................................................................................................. 5
   A. Legislative History .................................................................................................................... 5
   B. Effect of Section 707(a)(2)(B) on Pre-Existing Regulations .................................................... 7

IV. Conclusions and Recommendations .......................................................................................... 8
I. Executive Summary.

Section 707(a)(2)(B) of the Internal Revenue Code of 1986, as amended (the “Code”) was enacted originally in 1984 to codify the “disguised sale” rule of Treas. Reg. § 1.731-1(c)(3).

Treas. Reg. §1.731-1(c)(3) provides that if there is a contribution of property to a partnership and within a short period (a) before or after it other property is distributed to the contributing partner, or (b) after it the contributed property is distributed to another partner, the distribution may not be tax-free under section 731 but the transactions may be recast as exchanges. Thus, it covers the same transactions covered by section 707(a)(2)(B) and the regulations thereunder.

For simplification purposes, we recommend that Treas. Reg. § 1.731-1(c)(3) in its current form be replaced by a cross-reference to Section 707(a)(2)(B). Similar changes should also be made in Treas. Reg. §§ 1.721-1 and 1.708-1(b)(2), both of which currently refer to paragraph (c)(3) of Treas. Reg. § 1.731-1.

II. Paragraph (c)(3) of Treas. Reg. § 1.731-1.

A. Introduction.

Under section 721, a contribution to a partnership is generally a non-recognition event and under section 731 a distribution of property (other than cash or marketable securities) by a partnership to a partner is also generally a non-recognition event. However, it is possible that a transaction in the form of a contribution followed by a distribution could be characterized for tax purposes as a taxable sale.

Adopted in 1956 with the first set of partnership tax regulations under the 1954 Code, Treas. Reg. § 1.731-1(c)(3) provides that:

(3) If there is a contribution of property to a partnership and within a short period:

(i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or

(ii) After such contribution the contributed property is distributed to another partner,

such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect

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1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property.

Thus, paragraph (c)(3) of Treas. Reg. § 1.731-1 essentially excludes from the non-recognition treatment of Section 731 certain transactions more properly characterized as a sale or exchange of property.

For instance, in Rev. Rul. 57-200, 1957-1 C.B. 205, the Internal Revenue Service (the “Service”) considered the case of two partners who each transferred their one half interest in corporations X and Y to an existing partnership, and then liquidated the partnership and distributed all the stock of corporation X to one partner and all the stock of corporation Y to another partner. The Service found that the contribution of the stock to the partnership, followed immediately by the liquidation and selective distribution constituted steps in an integrated transaction designed to carry out an exchange of the corporate ownership interests between the partners. Citing Treas. Reg. § 1.731-1(c)(3), the Service concluded that the non-recognition treatment of Section 731 did not apply to the transaction.

B. Cross References.

Two other regulations also refer to paragraph (c)(3) of Treas. Reg. § 1.731-1.

(1) Treas. Reg. § 1.721-1(a) provides that a transfer of property from a partner to the partnership could be taxable if the substance of the transaction is a sale or exchange under Section 707 rather than a contribution under Section 721. This regulation refers to paragraph (c)(3) of Treas. Reg. § 1.731-1 for the proposition that “the substance of the transaction will govern, rather than its form.”

This cross-reference has been in Treas. Reg. § 1.721-1(a) since its adoption in 1956.³

(2) Treas. Reg. § 1.708-1(b)(2) provides that a contribution of property to a partnership does not constitute a sale or exchange that, if involving 50 percent or more of the total interests in capital and profits, could terminate a partnership for federal tax purposes. However, this regulation refers to paragraph (c)(3) of Treas. Reg. § 1.731-1 as a cautionary note, presumably alerting the taxpayer that if a formal partnership contribution is treated as a sale or exchange under the principles of Treas. Reg. § 1.731-1(c)(3), it would also be treated as a sale or exchange for purposes of the partnership termination analysis under Section 708.⁴

³ Id.


The Regulations provide that the acquisition of a partnership interest by contribution of property to a partnership does not constitute a sale or exchange. Where, however, the contribution accompanies the liquidation of an existing partner’s interest, the step transaction theory again may
Again, this cross-reference has been in Treas. Reg. § 1.708-1 since its adoption in 1956.\(^5\)

C. **Interpretation.**

By their own terms, the above regulation provisions merely restate the general proposition that the substance of a transaction will govern and to prevent abusive situations in which the taxpayer may try to recast a disguised sale as a combination of partnership contribution and distribution. *See, e.g.*, *Jacobson v. Commissioner*, 96 T.C. 577 (1991), *aff’d*, 963 F. 2d 218 (8\(^{th}\) Cir. 1992).

In *Jacobson*, the Tax Court considered the case where two partners formed a new partnership, with partner A contributing property and partner B contributing cash. The partnership then immediately distributed all the cash to or for the benefit of partner A. The Tax Court held that the transaction was in substance a sale by partner A of an interest in the contributed property to partner B. In its analysis, the Tax Court cited both paragraph (c)(3) of Treas. Reg. § 1.731-1 and Treas. Reg. § 1.721-1(a).

Notwithstanding the above anti-abuse provisions, a number of cases held in favor of the taxpayer. In the seminal case of *Otey v. Commissioner*, 70 T.C. 312 (1978), *aff’d per curia*, 634 F.2d 1046 (6\(^{th}\) Cir. 1980), the taxpayer contributed property to a new partnership. As agreed upon, the partnership immediately borrowed money in excess of its construction need and distributed to the taxpayer an amount equivalent to the value of his contribution. The amount distributed did not exceed the basis of his partnership interest, so the taxpayer realized no gain. The Service sought to treat the transaction as a sale. The Tax Court, however, accepted the form of the transaction and ruled in favor of the taxpayer.

III. **Section 707(a)(2)(B).**

A. **Legislative History.**

Congress believed that the anti-abuse provisions of Treas. Reg. §§ 1.721-1(a) and 1.731-1(c)(3) were not accomplishing their purpose and that cases such as *Otey* allowed inappropriate tax deferral for transactions which economically were indistinguishable from sales. In order to treat these transactions in a manner consistent with the underlying substance and to prevent taxpayers from abusing partnership tax treatment, Congress added Section 707(a)(2)(B) to the Code as part of the Deficit Reduction Act of 1984.\(^6\)
Section 707(a)(2)(B) provides that “under regulations prescribed by the Secretary”:7

(B) TREATMENT OF CERTAIN PROPERTY TRANSFERS. 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

(iii) the transfers described in clauses (i) and (ii), when viewed together, are property characterized as a sale or exchange of property,8

such transfers shall be treated either as a transaction described in paragraph (1) [as a transaction between a partnership and a non-partner] or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

The legislative comments to Section 707(a)(2)(B) described both Treas. Reg. § 1.721-1(a) and paragraph (c)(3) of Treas. Reg. § 1.731-1, and stated that:

The [regulations] do not always prevent de facto sales of property to a partnership or another partner from being structured as a contribution to the partnership, followed (or preceded) by a tax-free distribution from, the partnership. For example, under the case law, partner A may contribute $50,000 in cash to a partnership and partner B may contribute property with a basis of $50,000 and a fair market value of $100,000. If the partnership then transfers $50,000 in cash to partner B, partner B may claim that this $50,000 represents a distribution not exceeding his basis in the partnership and for which he is therefore not subject to tax. (The basis for partner B’s interest in the partnership would then be reduced from $50,000 to $0.) If this result is permitted, partner B has deferred or avoided tax on a transaction which closely resembles a sale of property to the partnership (or a partial sale to partner A followed by a joint contribution). Case law has permitted this result, despite the regulations described above, in cases which are economically indistinguishable from a sale of all or part of the property. See, Otey v. Commissioner, 70 T.C. 312 (1978), aff’d per curiam, 634 F.2d 1046 (1980); Communications Satellite Corp. v. United States 223 Ct. Cl. 253 (1980); Jupiter Corp. v. United States, No. 83-842 (Ct. Cl. 1983).

7 This is the initial clause of Section 707(a)(2), applicable to both 707(a)(2)(A) and 707(a)(2)(B).

8 As originally enacted by the Deficit Reduction Act of 1984, Section 707(a)(2)(B)(iii) used the phrase “sale of property.” The Tax Reform Act of 1986 amended Section 707(a)(2)(B)(iii) by replacing that phrase with “sale or exchange of property.” P.L. 99-514, § 1805(b). The amendment is effective as if included in the original enactment of Section 707(a)(2)(B).
Reasons for Change

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In the case of disguised sales, the committee is concerned that individuals have deferred or avoided tax on sales of property by characterizing sales as contributions of property followed (or preceded) by a related tax-free partnership distribution. Although Treasury regulations provide that the substance of the transaction should govern, court decisions have allowed tax-free treatment in cases which are economically indistinguishable from sales of property to a partnership. The committee believes that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance.


B. Effect of Section 707(a)(2)(B) on Pre-Existing Regulations.

The legislative history of Section 707(a)(2)(B) provides that:

No inference regarding the tax treatment of contribution arrangements or any similar transactions under existing law should be drawn from Congress’s action in adopting the disguised sale provision.


In Jacobson, supra, the Service argued that Section 707(a)(2)(B) was intended to codify the pre-existing regulations, i.e., paragraph (c)(3) of Treas. Reg. § 1.731-1 and Treas. Reg. § 1.721-1(a). Based on that argument, and given the express Congressional disapproval of the Otey line of cases, the Service asked the Tax Court to overrule Otey as incorrect. However, the Tax Court declined. Pointing to the above legislative history and the effective date of Section 707(a)(2)(B), the Tax Court concluded that the adoption of Section 707(a)(2)(B) in no way altered the law existing before its effective date, and therefore that Section could not be said to be a recodification of pre-existing regulations.

The Tax Court noted that the Otey case was correctly decided and its analysis remained applicable to property transfers before the effective date of Section 707(a)(2)(B), such as the

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property transfer at issue in Jacobson. However, the Tax Court distinguished the Jacobson transaction from the facts of Otey and found that the Jacobson transaction was a disguised sale.

In Jacobson, the Tax Court was concerned with the narrow issue of how much weight and deference it should accord Section 707(a)(2)(B) in deciding a case before its effective date. Although the Tax Court disagreed with the Service that Section 707(a)(2)(B) was a recodification of preexisting regulations, we believe that this disagreement only represents a dispute on judicial effect, and does not have any bearing on the substantive difference between Section 707(a)(2)(B) and the preexisting regulations. In a footnote, the Tax Court stated that it expressed no view as to whether the analysis of the Otey line of cases is appropriate in applying Section 707(a)(2)(B). Thus, the Tax Court did not go into the question whether Section 707(a)(2)(B) created a new standard, or whether it simply restated in statutory form the same basic “substance over form” principle of the pre-existing regulations. Subsequently, in a 1996 case, Carl Goudas v. Commissioner, T.C. Memo. 1996-555, aff’d, 137 F.3d 368 (6th Cir. 1998), the Tax Court cited both Section 707(a)(2)(B) and the preexisting regulations, including paragraph (c)(3) of Treas. Reg. § 1.731-1, as support for the proposition that partnership tax treatment did not apply to a transaction that was in substance a sale for cash.

According to the Partnership Taxation treatise by Willis, Pennell and Postlewaite,

Section 707(a)(2)(B) by itself adds nothing of substance that is not available under Regulations § 1.721-1(a) and § 1.731-1(c)(3) to resolving the question of the character of transfers between a partnership and a partner.


IV. Conclusions and Recommendations.

For 45 years, paragraph (c)(3) of Treas. Reg. § 1.731-1 has served to alert taxpayers that the general tax-free treatment of partnership distributions under Section 731 may not apply in certain “disguised sale” situations. Through cross reference, it also alerts taxpayers that the general rules regarding partnership contributions under Section 721 and regarding partnership terminations under Section 708 may not apply to transactions that could be properly characterized as sales.

Based on the legislative history and the plain language of Section 707(a)(2)(B), we believe that section was enacted to codify the “disguised sale” rule of existing regulations, including paragraph (c)(3) of Treas. Reg. § 1.731-1. Moreover, we believe that the statutory provision and the regulations of Section 707(a)(2)(B) now constitute the primary source of “disguised sale” authority, even though they do not add anything of substance to the pre-existing regulations.

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11 Otey, 70 T.C. at 589, footnote 6.
For simplification purposes, we believe it would be helpful to eliminate the current language of Treas. Reg. § 1.731-1(c)(3) and replace it with a short cross-reference to Section 707(a)(2)(B) and the regulations thereunder. Doing so would help minimize any confusion as to whether that paragraph represents an independent or different requirement aside from Section 707(a)(2)(B). It would also help streamline the partnership tax regulations, which are already replete with anti-abuse rules.

In addition, similar changes should also be made in Treas. Reg. §§ 1.721-1 and 1.708-1(b)(2), both of which currently refer to paragraph (c)(3) of Treas. Reg. § 1.731-1.