COMMENTS CONCERNING DISGUISED SALES OF PARTNERSHIP INTERESTS

The following comments are the individual views of the members of the Section of Taxation who prepared them. The comments do not represent the position of the American Bar Association or of the Section of Taxation and may not represent the position of the respective firms or organizations to which such members belong.

These comments were prepared by individual members of the Partnerships Committee of the Section of Taxation. Principal responsibility was exercised by Glenn Mincey and Eric Sloan. Substantive comments were received from Steven Klig, Terence Cuff, Barbara Spudis de Marigny, Phillip Gall, Howard Abrams, and Wayne Strasbaugh. The comments were reviewed by Robert Schachat of the Section’s Committee on Government Submissions and by Jerry August, 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 income tax rules applicable to the subject matter addressed by these comments, or have advised clients on the application of such rules, 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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EXECUTIVE SUMMARY

Section 707(a)(2)(B)\(^1\) was added to the Code by the Deficit Reduction Act of 1984.\(^2\) This provision grants to the Treasury Department (“Treasury”) and the Internal Revenue Service (the “IRS”) the authority to promulgate regulations concerning both disguised sales of property between partners and partnerships (the “Property Regulations”) and disguised sales of partnership interests (the “Interest Regulations”). The Property Regulations, which were promulgated in September of 1992,\(^3\) “reserved” on the subject of disguised sales of partnership interests.

The Interest Regulations, if promulgated by the IRS and Treasury, should balance the legitimate interests of the government in defeating abusive tax reduction schemes with two important taxpayer concerns. First, if principles from the Property Regulations were extended directly to the Interest Regulations, many legitimate business transactions (in which the parties neither contemplated nor expected a sale between the departing partner and the new partner) might be treated as disguised sales of partnership interests. For example, accounting, law, investment banking, and securities partnerships regularly admit partners for capital contributions and contemporaneously redeem the interests of pre-existing partners. These transactions are perhaps the most common transactions that would (at least presumptively) be treated as disguised sales of partnership interests if the Property Regulations were mechanically extended to such contributions and distributions. Generally, such transactions are factually unrelated to each other and are not properly treated as disguised sales of partnership interests. Additionally, in such transactions, any divergent tax consequences between treatment as a partnership redemption or as a sale of a partnership interest are typically not material to the terminating partner. Moreover, these routine, legitimate transactions should not be treated as disguised sales of partnership interests because to do so would result in a substantial compliance burden. Consistent with congressional intent, disguised sale of partnership interest treatment should be limited to \(related\) contribution and distribution transactions that are, in substance, sales of partnership interests.

Second, the government’s interest in defeating abusive tax reduction schemes must be balanced against tax complexity. Partnerships are a popular vehicle for small businesses. A partnership is more likely to be a small farm, medical practice, grocery store, software firm, trucking company, accounting firm, or law firm than it is to be a large sophisticated entity. The growing complexity of the rules governing partnership taxation challenges the skills of even the most sophisticated partnership tax specialists and auditing agents working for the IRS. Such complexity is inconsistent with a voluntary compliance system.

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\(^{1}\) Unless otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Reg. §” references are to the Treasury Regulations promulgated under the Code.


These factors suggest that regulations concerning disguised sales of partnership interests should be drafted more narrowly than rules concerning disguised sales of property, where the potential for tax abuse was material.

**Principal Recommendations**

We recommend that the Interest Regulations provide that:

1. If (i) there is a direct or indirect transfer of money or other property by one or more partners to a partnership resulting in an increase in the partnership interest of the transferor partner(s), (ii) there is a related direct or indirect transfer of money or other property by the partnership to one or more other partners resulting in a corresponding decrease in the partnership interest(s) of the transferee partner(s), and (iii) each transfer described in clause (i) and (ii) would not have been made but for the other transfer, such transfers will be treated as a sale of a partnership interest by the transferee partner(s) to the transferor partner(s).

2. The Interest Regulations will include neither taxpayer-favorable nor taxpayer-adverse presumptions based upon the amount of time that elapses between a contribution and a distribution.

3. The Interest Regulations will establish a safe harbor that provides an exception from recharacterization under the Interest Regulations for routine contributions to and distributions from (i) professional service partnerships (e.g., partnerships providing legal, accounting, architectural, consulting, or medical services); (ii) securities partnerships; and (iii) partnerships involved in staged closings.

4. A transaction that involves a contribution by one or more partners of the capital required to be contributed by a defaulting partner, and a concomitant readjustment of partnership interests, will not be considered a disguised sale of a partnership interest.

5. The allocation or reallocation of partnership liabilities under section 752 will not be treated as being part of or giving rise to a disguised sale of a partnership interest.

6. Distributions financed from partnership-level debt will not be considered part of a disguised sale of a partnership interest.

7. A transfer that is treated as a sale of a partnership interest under the Interest Regulations will be treated as a sale for all purposes of the Code.

8. In the case of overlap between the rules governing disguised sales of property and disguised sales of partnership interests, the rules of Treas. Reg. § 1.707-3 through -6 will apply before the rules of Treas. Reg. § 1.707-7.
9. The Interest Regulations will not apply to any transaction in which the amount of aggregate consideration that otherwise would be treated as sale proceeds does not exceed the lesser of (i) $250,000 (adjusted for inflation) or (ii) ten percent of the net fair market value of all of the interests in the partnership.

**BACKGROUND**

I. General Background

The principal objectives of the drafters of subchapter K were simplicity, flexibility, and equity as between the partners. Accordingly, subchapter K permits partners to determine their tax burdens among themselves to a certain extent, expecting the partners to take into account their respective tax liabilities in bargaining with each other. Nevertheless, such flexibility is limited by many statutory provisions, as well as the principle that the substance, rather than the form, of a transaction should control for tax purposes.

Under section 731, when a partnership distributes money to a partner, the partner generally does not recognize gain, except to the extent that the amount of money distributed exceeds the partner’s adjusted basis in its partnership interest immediately before the distribution. Section 731 was not intended to apply, however, if the distribution was made to affect an exchange of property between two or more partners or between the partnership and a partner. Indeed, since 1956, the Treasury regulations have provided that, if there is a contribution of property by a partner to a partnership and (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 by the partnership to another partner, the distribution may not fall within the scope of section 731. Therefore, since 1956, certain contributions and related distributions have been excluded from the ambit of section 731.

Prior to 1984, there was considerable controversy between taxpayers and the IRS concerning related contribution and distribution transactions that the IRS believed were, in substance, sales. A typical transaction involved (i) a contribution of appreciated property to a partnership, followed by (ii) a related distribution of money to the contributor of the appreciated property. The IRS was consistently unsuccessful in litigating cases in this area.

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7 Section 731(a)(1).
8 Treas. Reg. § 1.731-1(c)(3).
9 Id.
For example, in *Otey v. Commissioner*, the taxpayer contributed real property with a fair market value of $65,000 to a partnership. The partnership borrowed $870,000, in part to fund a construction project, and distributed $65,000 of the loan proceeds to the taxpayer. For a number of reasons, the Tax Court found that the transaction did not have the normal indicia of a sale of property. First, the court noted that the form of the transactions was a contribution to capital rather than a sale, and there were no elements of artificiality that induced the court to look beyond the form. Second, the real property contributed to the partnership was the only asset of the partnership (other than the borrowed funds). Without the transfer of property, the partnership would have had no assets and no business. Thus, in the court’s view, it would have been difficult to find that the transaction was between the taxpayer and the partnership other than in the taxpayer’s capacity as a partner. Third, the taxpayer had no guarantee that he would receive the $65,000 distribution. Although most of the taxpayer’s capital was indeed distributed to him immediately from the borrowed funds, the court noted that the taxpayer remained personally liable for the entire borrowing. Finally, the court found as commonplace an arrangement in which a partner who invested a greater share of capital would receive preferential distributions to equalize capital accounts. For these reasons, the Tax Court held that the transaction was not a sale of the real property to the partnership.

In *Communications Satellite Corp. v. United States*, an international communications consortium admitted new partners pursuant to a formula the purpose of which was to place the new partners in the same position in which they would have been had they been partners from the partnership’s inception. The partnership distributed pro rata to the existing partners the money that the new partners contributed. In reaching its conclusion that the transactions were not disguised sales of partnership interests, the court emphasized that the new partners and the historic partners did not negotiate sales of partnership interests; moreover, the historic partners had no control over the admission of the new partners. In addition, the court found as significant “the unique and special nature and purpose of th[e] partnership,” that is, to admit new members not for economic advantage but to extend access to the international communications satellite network as broadly as possible. For these reasons, the court found that it was inconsistent to view the contributions and distributions as sales by the existing partners. Thus, the court held that the transactions were not disguised sales of partnership interests.

Another case involving a contribution of property and a related distribution was *Jupiter Corp. v. United States*. In *Jupiter Corp.*, a real estate partnership was owned by a general partner with a 77.5 percent interest and a limited partner with a 22.5 percent interest. The general partner sought capital contributions from new investors to help fund partnership operations. The investors wished to obtain (in the aggregate) a twenty-percent limited partnership interest that would entitle them to cumulative preferential rights to monthly distributions of cash. Because the existing limited partner did not wish to reduce its partnership interest, the general partner agreed to receive distributions sufficient to reduce its partnership interest by twenty percentage points, to 57.5 percent.

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10 70 T.C. 312 (1978), aff’d per curiam, 634 F.2d 1046 (6th Cir. 1980).
11 625 F.2d 997 (Ct. Cl. 1980).
The transaction could not have been accomplished simply by the general partner’s selling a twenty percent interest to the prospective partners because the prospective partners wanted partnership interests that were materially different from the interest owned by the general partner. The court specifically found that, because the general partner would not have considered selling, and the prospective partners would not have considered purchasing, a portion of the general partner’s interest, it was necessary for the parties to structure the transaction as a contribution by the prospective partners and a distribution to the general partner. Thus, the court held that the transaction was not a sale and was instead nontaxable to the general partner under section 731, because the distribution to the general partner did not exceed its adjusted basis in its partnership interest.

Apparently motivated, at least in part, by the government’s losses in these cases, Congress, in the Deficit Reduction Act of 1984, added section 707(a)(2)(B) to the Code. The new Code provision authorized Treasury to promulgate regulations to address abusive situations in which there is a direct or indirect transfer of money or other property by a partner to a partnership, there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and the two transfers, when viewed together, are properly characterized as a sale or exchange of property. Under regulations to be promulgated after the enactment of section 707(a)(2)(B), these transactions were to be treated as transactions between a partner or partners acting other than in their capacity as members of the partnership. That is, the transactions would generally be treated as taxable purchase and sale transactions. Final Property Regulations were promulgated in September of 1992. These regulations “reserved” on the subject of disguised sales of partnership interests.

It has been argued that the IRS may not have authority to attack disguised sales of partnership interests under the language of section 707(a)(2)(B). We believe, however, that, even in the absence of regulations, the IRS has sufficient authority under the Code and legislative history to attack appropriate transactions as disguised sales of partnership interests. The IRS shares that belief.

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13 Supra note 2.

14 See supra note 3.


16 See, e.g., T.A.M. 200301004 (Jan. 3, 2003) (the IRS concluded that, even though no regulations for disguised sales of partnership interests have been promulgated, the IRS could enforce section 707(a)(2)(B)); I.L.M. 200250013 (Aug. 31, 2002) (in analyzing the distribution of a partnership’s historic business to a partner in liquidation of the partner’s interest, the IRS alternatively attacked the transaction as a disguised sale of property and a disguised sale of a partnership interest, as well as under the anti-abuse provision of Treas. Reg. § 1.731-2(h)); T.A.M. 200037005 (Sept. 15, 2000) (transactions resulting in reconfiguration of a partnership into an umbrella partnership real estate investment trust were recharacterized as a sale of part of a partnership interest to another partnership and the real estate investment trust); F.S.A. 200024001 (Feb. 8, 2000) (in a transaction in which, after a partnership agreed to redeem the interests of a partner, another partner made capital contributions to fund the redemption payments, the IRS recharacterized the arrangement as a disguised sale of a partnership interest). Given the manner in which the facts of the transactions are presented in the guidance, it is not clear whether the IRS’s views regarding each of these specific transactions are correct.
II. Divergent Tax Consequences

To understand the importance of the characterization of a transaction as a contribution and unrelated distribution, rather than as a sale, it is necessary to understand the different tax consequences associated with each characterization. Not only are the immediate implications of gain or loss recognition important, but other consequences, such as basis adjustments, revaluation of partnership property, section 704(c) implications, and the rules of section 751 may have continuing effects. The more significant of these issues are summarized below.

A. Gain or Loss Recognition

The most immediate difference between the taxation of a series of transactions as a contribution by one partner, increasing that partner’s interest, followed by a distribution to another partner, decreasing that partner’s interest, rather than as a sale of a partnership interest, is the nonrecognition of gain upon contribution (under section 721(a)) followed by the nonrecognition of gain and favorable basis recovery upon a distribution (under section 731(a)). Significantly, if a cash distribution results in the complete redemption of the distributee’s partnership interest, the amount of gain (or loss) recognized normally will be the same under either a sale characterization or a contribution and distribution characterization. The tax consequences may diverge substantially, however, if the distribution transaction does not result in the complete redemption of the distributee’s partnership interest. In such a case, if the transaction is characterized as a distribution, the partner is permitted to recover all of her tax basis in her partnership interest before recognizing gain. If the transaction is characterized as a sale of a partnership interest, however, the partner must allocate her basis between the portion of her partnership interest she transferred and the portion of her partnership interest she retained. Gain (or loss) is recognized to the extent of the difference between the selling price and the basis allocated to the partnership interest transferred.17

B. Section 704(c)

The proper characterization of a transaction will dictate the manner in which section 704(c) applies. Under section 704(c)(1)(A), a partnership must allocate items of income, gain, loss, and deduction with respect to section 704(c) property among its partners so as to take into account the variation between the tax basis of the property and its fair market value at the time of contribution.18 Accordingly, section 704(c)(1)(A) can affect the computation and allocation of depreciation deductions and gain on sale of the section 704(c) property. Moreover, because the purchaser of a partnership interest is a successor partner for purposes of

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17 Treas. Reg. § 1.61-6(a). See also Rev. Rul. 84-53, 1984-1 C.B. 159 (providing that a partner has a single basis in a partnership interest, even if such partner is both a general partner and a limited partner of the same partnership, and providing examples of how to allocate basis between the interest retained and the interest sold when liabilities are allocable to the selling partner under section 752).

18 Section 704(c)(1)(A); Treas. Reg. § 1.704-3(a)(1). “Section 704(c) property” is property contributed to a partnership with a fair market value different from the contributing partner’s adjusted tax basis in the property at the time of contribution. Treas. Reg. § 1.704-3(a)(3)(i).
section 704(c)(1)(A) with respect to section 704(c) property contributed by the selling partner, a “purchaser” in a disguised sale of a partnership interest would be treated as a successor partner for purposes of section 704(c). Furthermore, the characterization of a transaction as a sale or unrelated contribution and distribution can affect the manner in which section 704(c)(1)(B) and section 737 (the “anti-mixing bowl rules”) apply.20

C. Revaluation of Partnership Property

A partnership may increase or decrease the capital accounts of its partners to reflect a revaluation of partnership property.21 Under the regulations, a partnership may revalue its assets only: (i) in connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership; (ii) in connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership; or (iii) under generally accepted industry accounting practices, provided substantially all of the partnership’s property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.22 When a partnership revalues its assets, the partnership must determine the fair market value of each item of partnership property at the time of the revaluation event and reflect the manner in which unrealized income, gain, loss, or deduction inherent in the property would be allocated among the partners if there had been a taxable disposition of the property at its fair market value on the date of the revaluation.23 After the revaluation, the partners’ capital accounts are adjusted for the partners’ distributive shares of “book” gain, loss, depreciation, or amortization with respect to the restated book value of the property (i.e., the fair market value of the property at the time of the revaluation).24 Finally, the partners’ distributive shares of tax gain, loss, depreciation, or

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19 Treas. Reg. § 1.704-3(a)(7).

20 Section 704(c)(1)(B) applies if section 704(c) property is distributed by the partnership to a partner other than the contributing partner (or his successor) within seven years of its contribution. Treas. Reg. § 1.704-4(a)(1); Treas. Reg. § 1.704-4(d)(2). Similarly, section 737 applies if a partner that contributed section 704(c) property to a partnership (or his successor) receives a distribution of other property within seven years of such contribution. Treas. Reg. § 1.737-1(a)(1). Note that, although Treas. Reg. § 1.737-1(c)(2)(iii) provides that the transferee of a partnership interest succeeds to the transferor’s net precontribution gain, the section 737 regulations are otherwise silent with respect to the application of section 737 to a transferee.


amortization with respect to the property are determined at the time of the revaluation by taking into account the variation between the tax basis and the fair market value of the revalued property in the same manner as under section 704(c)(1)(A) with respect to contributed property.\footnote{25}

To the extent that a transaction is treated as an unrelated contribution and distribution, both the contribution and the distribution would permit the partnership to revalue its assets. If, on the other hand, a transaction is treated as a sale of a partnership interest, there is no opportunity to revalue partnership property under Treas. Reg. § 1.704-1(b)(2)(iv)(f).

D. \textbf{Basis Adjustments}

If a transaction is treated as a distribution under section 731, then, under certain circumstances, basis adjustments to partnership property may be made under the rules of section 734(b). Section 734(b) provides that, in the case of a distribution to a partner, if a partnership has a section 754 election in effect, the partnership must (i) increase the partnership’s adjusted basis of partnership property by (a) the amount of any gain recognized to the distributee partner with respect to a distribution, and (b) any excess of the adjusted basis of the distributed property to the partnership before the distribution over the adjusted basis of the property to the distributee partner; and (ii) decrease the partnership’s adjusted basis of partnership property by (a) the amount of any loss recognized to the distributee partner with respect to a distribution, and (b) any excess of the adjusted basis of the distributed property to the distributee partner after the distribution over the adjusted basis of the property to the partnership.

If, on the other hand, a transaction is treated as a sale of a partnership interest, basis adjustments to partnership property may be made under section 743(b). Section 743(b) provides that, if a partnership has a section 754 election in effect, the partnership must (i) increase the adjusted basis of partnership property by the excess of the transferee partner’s basis in its partnership interest (“outside basis”) over the transferee partner’s proportionate share of the adjusted basis of the partnership property (“inside basis”); or (ii) decrease the adjusted basis of partnership property by the excess of the transferee partner’s proportionate share of inside basis over the transferee’s outside basis.\footnote{26}

Not only are adjustments under section 734(b) and section 743(b) determined differently, such adjustments are allocated among partnership assets differently under section 755. Section 734(b) adjustments are allocated to the remaining partnership property of a character similar to that of the distributed property that gave rise to the adjustment.\footnote{27} Section 743(b) adjustments, on the other hand, are allocated among ordinary and capital assets in a


\footnote{26} A bill has been introduced in the House of Representatives that contains numerous tax reform provisions, including mandatory basis adjustments in certain situations. American Jobs Creation Act of 2003, H.R. 2896, 108th Cong. § 3024 (2003). Additionally, legislation introduced by the Senate would simply repeal section 754 and make basis adjustments mandatory in all circumstances. Jumpstart Our Business Strength Act, S. 1637, 108th Cong. §§ 469(a) and (b) (2003).

\footnote{27} Treas. Reg. § 1.755-1(c)(1).
manner that is intended (in most situations) to eliminate all built-in gain and built-in loss attributable to a transferee’s interest in the partnership.\textsuperscript{28} Moreover, an adjustment under section 734(b) is made to the partnership’s “common” asset basis. Therefore, an adjustment under section 734(b) will affect all of the partners. In contrast, an adjustment under section 743(b) is a “special” adjustment that is solely for the benefit of the purchasing partner: no adjustment is made to the common asset basis of partnership property.\textsuperscript{29}

E. Section 751

Gain or loss recognized on the sale or exchange of an interest in a partnership is generally considered to be gain or loss from the sale or exchange of a capital asset, except as provided under section 751(a).\textsuperscript{30} Section 751(a) provides that, if the partnership holds ordinary income assets described in sections 751(c) and (d) (unrealized receivables or inventory items of the partnership), all or a portion of the gain or loss may be recharacterized as ordinary income or loss.\textsuperscript{31}

Even if the sale of a partnership interest does not result in the application of section 751(a), section 1(h) will apply if the partnership has “unrecaptured section 1250 gain.”\textsuperscript{32} To the extent section 1(h) applies,\textsuperscript{33} gain on such sale may be subject to twenty-five percent tax,\textsuperscript{34} much more than the fifteen-percent rate generally applicable to capital gains.\textsuperscript{35}

Sections 751(a) and 1(h) are inapplicable to partnership distributions. Instead, section 751(b) generally provides that, to the extent that a partner receives a distribution of

\textsuperscript{28} See Treas. Reg. § 1.755-1(b).
\textsuperscript{29} Treas. Reg. § 1.743-1(j)(1).
\textsuperscript{30} Section 741.
\textsuperscript{31} It should be noted that the gain or loss recharacterized as ordinary is not limited to the net gain or loss recognized on the sale or exchange of the partnership interest. Rather, the ordinary gain or loss is the amount of gain or loss from unrealized receivables or inventory items of the partnership that would have been allocated to the partner with respect to the interest sold or exchanged if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property. Treas. Reg. § 1.751-1(a)(2). As a result, a selling partner may recognize under section 751(a) ordinary income in excess of net gain recognized on the sale of the interest. In that event, the partner would recognize an offsetting capital loss.
\textsuperscript{32} “Unrecaptured section 1250 gain” is determined by reference to the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if “additional depreciation” included all depreciation and the applicable percentage under section 1250(a) were 100 percent. Section 1(h)(6)(A).
\textsuperscript{33} The regulations under section 1(h) impose rules similar to section 751(a) with respect to the sale of a partnership interest when the partnership has built-in unrecaptured section 1250 gain. Treas. Reg. § 1.1(h)-1(b)(3)(ii). Specifically, Treas. Reg. § 1.1(h)-1(b)(3)(ii) provides that, when a partner sells a partnership interest that he has held for more than one year, in determining the partner’s unrecaptured section 1250 gain, the partner will take into account the partner’s allocable gain (to the extent attributable to the interest transferred) if the partnership transferred all of its section 1250 property for cash equal to the fair market value of the assets immediately before the transfer of the interest in the partnership.
\textsuperscript{34} Section 1(h)(1)(D).
\textsuperscript{35} Section 1(h).
property in exchange for any part of his interest attributable to unrealized receivables or
substantially appreciated inventory items,

the distribution will be treated as a sale or exchange of such property between the partner and the partnership, generally resulting in the partner recognizing ordinary income (and the partnership perhaps recognizing gain as well).

F. **Technical Terminations**

A partnership is considered continuing if it is not terminated. Under section 708(b)(1)(B), a partnership is considered terminated if, within a twelve-month period, there is a sale or exchange of fifty percent or more of the total interests in partnership capital and profits.

While a partnership termination under section 708(b)(1)(B) generally should not result in immediate direct tax consequences, it may produce significant collateral tax consequences. For example, for purposes of depreciation deductions under section 168, the new partnership must “restart” the depreciable lives of its assets following a termination under section 708(b)(1)(B). Therefore, the new partnership must compute depreciation with respect to such assets as if the assets were newly placed in service at the time of the termination.

G. **Section 736**

Section 736(a) provides that payments made in liquidation of the interest of a retiring partner or a deceased partner are considered to be either (i) a distributive share of partnership income to the recipient if the amount of the payment is determined with regard to the income of the partnership, or (ii) a guaranteed payment if the amount of the payment is determined without regard to the income of the partnership. Under section 736(b), however, to the extent that payments made in liquidation of the interest of a retiring partner or a deceased partner are made in exchange for the interest of such partner in partnership property, such payments generally are considered to be a distribution by the partnership and not as a distributive share or guaranteed payment under section 736(a).

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36 Section 751(b)(1).
37 Treas. Reg. §§ 1.751-1(b)(2) and (3).
38 Section 708(a).
39 Fifty percent or more of the total interest in partnership capital and profits means fifty percent or more of the total interest in the partnership capital plus fifty percent or more of the total interest in partnership profits. Treas. Reg. § 1.708-1(b)(2).
40 Section 168(i)(7)(B).
41 Additionally, a technical termination may cause section 481(a) adjustments to accelerate and may result in “recapture” under section 904(f)(5). See Rev. Proc 97-27, 1997-1 C.B. 680, § 7.03(3)(b)(v) (the contribution to a partnership of the assets of a trade or business to which a section 481(a) adjustment relates accelerates the section 481(a) adjustment).
If a transaction is respected as a contribution and unrelated distribution, section 736 may apply to the distribution. If, on the other hand, a transaction is treated as a sale of a partnership interest, section 736 would be inapplicable.42

**H. Holding Periods**

The holding period of a partnership interest includes the holding period of any capital asset or section 1231 asset contributed to the partnership in a nonrecognition transaction in exchange for an interest in a partnership.43 The holding period of property that a partner has received in a distribution from a partnership includes the partnership’s holding period of the distributed asset.44 The holding period of a partnership interest acquired by purchase, however, begins anew on the date after acquisition of the interest.45

**DETAILED COMMENTS**

**I. Legislative History and Regulatory Authority**

The Property Regulations promulgated under section 707(a)(2)(B) were issued pursuant to a specific grant of regulatory authority.46 Section 707(a) provides:

(a) Partner not acting in capacity as partner.
   (1) In general. If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.
   (2) Treatment of payments to partners for property or services. Under regulations prescribed by the Secretary—

   **(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,

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42 See Foxman v. Commissioner, 41 T.C. 535, aff’d, 352 F.2d 466 (3d Cir. 1965), acq. 1966-2 C.B. 4 (where the complete redemption of a partner could have been effected as a distribution under section 736 or as a sale, the Tax Court respected the partners’ form of engaging in a sale of a partnership interest, rendering section 736 inapplicable).

43 Sections 1223(1) and 722.

44 Section 735(b).


(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 properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between [two] or more partners acting other than in their capacity as members of the partnership.

Although the legislative language may not be the model of clarity, it seems broad enough to support regulations addressing disguised sales of partnership interests.

Moreover, the legislative history underlying section 707(a)(2)(B) explains that Congress anticipated that Treasury regulations would apply the provisions of section 707(a)(2)(B) when a distribution is related to a contribution in such manner that, “taking into account all the facts and circumstances, the transaction substantially resembles a sale or exchange of all or part of the property (including an interest in the partnership).” Indeed, the House Report specifically states:

[W]hen a partner transfers money or other property to a partnership and there is a related direct or indirect transfer of money or other property to that partner or other [sic] partner, the transaction is to be treated (as appropriate) as a sale between the partners of property (including partnership interests) or as a partial sale and partial contribution of the property to the partnerships [sic].

Additionally, the legislative history specifically mentions Otey, Communications Satellite Corp., and Jupiter Corp. As was discussed above, both Communications Satellite Corp. and Jupiter Corp. were cases involving potential disguised sales of partnership interests. Thus, there seems to be little doubt that, in enacting section 707(a)(2)(B), Congress intended to provide authority to promulgate regulations addressing disguised sales of partnership interests.

II. Regulations Should Be Narrowly Drafted

In enacting section 707(a)(2)(B), Congress had a narrow focus. Specifically, “Congress was concerned that taxpayers had deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed, or preceded, by a related partnership distribution.” That is, Congress sought

47 The House Report, at 1220 (emphasis added); the Senate Report, at 230 (emphasis added).
48 The House Report, at 1220 (emphasis added); see also the Senate Report, at 230.
49 The House Report, at 1218; the Senate Report, at 227.
to prevent transactions in which, even though the parties did not document a transaction as a sale, the intent of the parties was in fact to engage in a sale, and the involvement of the partnership was a mere subterfuge. Stated differently, Congress sought to treat such transactions in a manner consistent with their underlying economic substance.

Consistent with congressional intent, the IRS and Treasury, in drafting the Property Regulations, determined that, when a partner transfers property to a partnership, nominally as a contribution, the partnership transfers property to the partner, nominally as a distribution, and the combined effect is to allow the transferring partner to withdraw all or a part of his equity in the transferred property, the transaction generally should be considered to be a sale of property to the partnership. To discern the intention of the parties to engage in a sale, the Property Regulations ask whether there has been a transfer of property, and whether there has been a related transfer of money or other consideration that would not have been made but for the transfer of property.

The Interest Regulations should be directed toward the same inquiry and result. The determination of when a contribution and distribution, when viewed together, should be recharacterized as a sale or exchange of a partnership interest should be based upon some indication that the parties intended to sell a partnership interest. That is, the Interest Regulations should be conditioned upon some sort of mutual assent between the “selling partner” and the “purchasing partner.” This is not to suggest that the Interest Regulations should apply only upon the formal expression of an offer and acceptance, but rather that the regulations should treat a transaction as the sale of an interest only when it is apparent that the selling partner and the purchasing partner each agreed to or expected a particular result, or reached a “meeting of the minds” with regard to a sale and purchase of a partnership interest.

Although the Property Regulations certainly serve as a useful framework for the IRS, the Interest Regulations should be more narrowly drafted than the Property Regulations for two specific reasons. First, the Interest Regulations would impose a more substantial recharacterization upon a particular transaction than the Property Regulations currently impose. As discussed in more detail below, the Property Regulations apply to a transfer of property by a partner to a partnership and a related transfer of money or other consideration by the partnership to the partner. Even if the Property Regulations apply to alter the tax consequences of a particular transaction, the transaction is still considered to be a transaction between the transferor and the partnership. No new steps are created. All that happens is that the transaction becomes taxable in whole or in part. The Interest Regulations, on the other hand, would apply to two separate transactions: one between the contributing partner and the partnership, and another between the partnership and the distributee partner. If the Interest Regulations apply, both transactions would be recharacterized as a transaction between the contributing partner and the

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52 Treas. Reg. § 1.707-3(b)(1).
53 Id.
distributee partner, with all of the consequences attendant to a sale of a partnership interest.\textsuperscript{54} Thus, the Interest Regulations would recharacterize two transactions involving three separate parties into one transaction involving two separate parties.

The Interest Regulations should also be narrowly drafted because disguised sales of partnership interests offer limited potential for tax abuse. While the legislative history of section 707(a)(2)(B) indicates that Congress intended to grant broad authority to the IRS and Treasury to prescribe regulations with respect to disguised sales, Congress was concerned with disguised sales and not “with non-abusive transactions that reflect the various economic contributions of the partners.”\textsuperscript{55} As we have discussed, in contrast to disguised sales of property, transactions that might at first blush appear to be disguised sales of partnership interests often involve legitimate business transactions in which the parties neither contemplated nor expected a sale between the departing partner and the new partner. This consideration encourages drafting regulations addressing disguised sales of partnership interests narrowly so as not to inhibit or to complicate normal, business transactions. For these reasons, we believe that the Interest Regulations should be limited and narrowly drafted to address perceived abuses and to otherwise clarify the law.

\textbf{A. The IRS and Treasury Should Borrow Certain Rules From the Property Regulations}

As was discussed above, the Interest Regulations should, like the Property Regulations, seek to determine whether a sale was intended by the parties. Because the Interest Regulations should be narrower in scope than the Property Regulations, however, it would be inappropriate to incorporate all of the concepts found in the Property Regulations. Thus, we believe the IRS and Treasury should borrow only certain provisions from the Property Regulations.

\textbf{1. A Modified “But For” Test Should Apply to a Disguised Sale of a Partnership Interest}

The Property Regulations provide a “but for” test (the “single but for test”) for disguised sales of property:

\begin{quote}
(b) Transfers treated as a sale.
(1) In general. A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances –
\end{quote}

\textsuperscript{54} \textit{See supra} Background, Section II.

\textsuperscript{55} The House Report, at 1220; the Senate Report, at 230. \textit{See also} the preamble to the proposed Property Regulations, 56 Fed. Reg. 19,055.
(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.  

The single but for test distinguishes many related contributions and distributions, which are properly treated as sales, from unrelated contributions and distributions, which are not properly treated as sales. The use of a single but for test in the Interest Regulations would have the advantage of being consistent with the test in the Property Regulations. Nevertheless, as discussed above, although the objective of the Interest Regulations is similar to that of the Property Regulations, many legitimate business transactions might be treated as disguised sales of partnership interests if principles from the Property Regulations were extended too broadly to the Interest Regulations. Thus, we do not advocate the inclusion of a single but for test in the Interest Regulations.

The Interest Regulations should apply to recharacterize a transaction as a disguised sale of a partnership interest only when it can be determined that the selling partner and the purchasing partner each agreed to or expected a particular result, or reached a “meeting of the minds” with regard to the sale and purchase of a partnership interest. To make this determination, we suggest the Interest Regulations treat a transaction as a sale only if the partner’s contribution would not have been made but for the distribution to the departing partner, and the distribution to the departing partner would not have been made but for new partner’s contribution (a “double but for test”).

For example, assume that partners A and B each own a 50 percent interest in Partnership AB, which is worth $100. C wishes to invest $50 in Partnership AB, but wants a 50 percent interest in the profits, losses, and capital of Partnership AB. Toward that end, C contributes $50 to Partnership AB, which Partnership AB then distributes to A and B, reducing each partner’s interest to 25 percent. C’s contribution would not have been made but for the distribution to A and B, and the distribution to A and B would not have been made but for C’s contribution. This transaction should be considered a sale of a partnership interest from A and B to C in exchange for cash.

The double but for test is consistent with the results sought by the government in the courts and by Congress in the legislative history to section 707(a)(2)(B) with respect to both Communications Satellite Corp. and Jupiter Corp. In Communications Satellite Corp., a pro-

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56 Treas. Reg. § 1.707-3(b)(1) (emphasis added).

57 Some commentators have suggested that the Interest Regulations should adopt a single but for test. See Tax Section of the New York State Bar Association, Report on Disguised Sales of Partnership Interests, 2003 TAX NOTES 44-15, at 12 (Feb. 13, 2003) (the “NYSBA Report”). Although we believe that a single but for test could reach the correct result in most cases if the Interest Regulations included additional facts and circumstances and regulatory safe harbors, we believe that a narrowly tailored test is more likely – on its own – to reach the correct result. This will greatly reduce the burden on taxpayers and the government and reduce the number of additional facts and circumstances and safe harbors that will be necessary.
rata distribution to the existing partners of capital from the new partners was critical to maintaining the economic arrangement of the partners. In other words, the contributions would not have occurred but for the distributions, and the distributions would not have occurred but for the contributions. Similarly, in Jupiter Corp., the prospective partners wished to obtain a twenty percent interest with their contributions to the partnership, but such contributions were insufficient to obtain a twenty percent interest. The only way to facilitate the prospective partners’ desires was for the general partner to receive a distribution sufficient to reduce its partnership interest by twenty percentage points. Once again, the contributions would not have occurred but for the distribution, and the distribution would not have occurred but for the contribution.

Thus, we propose that the Interest Regulations provide that if (i) there is a direct or indirect transfer of money or other property by one or more partners to a partnership resulting in an increase in the partnership interest of the transferor partner(s), (ii) there is a related direct or indirect transfer of money or other property by the partnership to one or more other partners resulting in a corresponding decrease in the partnership interest(s) of the transferee partner(s), and (iii) each transfer described in clause (i) and (ii) would not have been made but for the other transfer, such transfers will be treated as a sale of a partnership interest by the transferee partner(s) to the transferor partner(s).

2. Facts and Circumstances Should Continue to Be Relevant

The Property Regulations include ten facts and circumstances that are relevant in determining whether a transaction is a disguised sale of property.\(^{58}\) We believe that such facts

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\(^{58}\) The factors listed under Treas. Reg. § 1.707-3(b)(2) are:

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

(ii) That the transferor has a legally enforceable right to the subsequent transfer;

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

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

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

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

(vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);
and circumstances are also relevant in addressing disguised sales of partnership interests. Thus, we suggest that the Interest Regulations include the facts and circumstances set forth in the Property Regulations, with an emphasis on those factors that indicate an intention to minimize the entrepreneurial risk to which the departing partner’s distribution is subject. Specifically, the Interest Regulations should place an emphasis on those facts and circumstances delineated in the Property Regulations that either determine or ensure certainty as to the amount, timing, enforceability, or source of the departing partner’s distribution.

Other commentators have suggested that the Interest Regulations include a number of new facts and circumstances that are predominantly relevant to determining whether the contributing partner and the distributee partner have negotiated the purchase and sale of a partnership interest. Although we believe that the double but for test should be sufficiently determinative of whether the parties have negotiated the purchase and sale of a partnership interest, such additional facts and circumstances may also be helpful in making this determination.

3. The Interest Regulations Should Not Include Timing Presumptions

For the reasons discussed below, we believe that the Interest Regulations should include neither taxpayer-favorable nor taxpayer-adverse presumptions based upon the amount of time that elapses between a contribution and a distribution.

The Property Regulations contain two “timing presumptions.” Transfers between a partnership and a partner that occur within two years of each other (regardless of their order) are presumed to be part of one sale transaction (the “taxpayer adverse presumption”). This presumption can only be rebutted by facts and circumstances that clearly establish that the transfers do not constitute a sale. Transfers between a partnership and a partner that occur more than two years apart are presumed not to be related and, thus, not to constitute a sale of partnership property.

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

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

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

See the NYSBA Report, at 12-14.

Treas. Reg. § 1.707-3(c)(1).

Id.
property (the “taxpayer favorable presumption”).\textsuperscript{62} Such presumption can only be rebutted by facts and circumstances that \textit{clearly establish} that the transfers constitute a sale.\textsuperscript{63} 

The legislative history to section 707(a)(2)(B) noted that a transaction would be treated as a sale when a partner contributed property to a partnership and received a distribution of money or property “within a reasonable period before or after such contribution.”\textsuperscript{64} While the two-year presumptions in the Property Regulations were evidently intended to be responsive to the legislative history and to promote taxpayer certainty, the utility of the two-year presumptions is not entirely apparent. Although the presumptions provide definite temporal limitations, the presumptions have done little to enhance taxpayer certainty. Rather, taxpayers analyze whether a disguised sale of property has occurred by examining the facts and circumstances of a particular transaction, thus causing the facts and circumstances largely to supplant the presumptions. Because it is not clear what timing presumptions would add to the Interest Regulations – other than disclosures with respect to transactions occurring within the relevant time period\textsuperscript{65} – it is difficult to endorse the inclusion of timing presumptions in the Interest Regulations.

Moreover, timing presumptions are less relevant to the determination of a disguised sale of a partnership interest than they are to the determination of a disguised sale of property. A presumption should be used when the facts underlying the presumption are probative of the presumed legal conclusion. In the Property Regulations, the two-year presumption is probative because, if two years elapse between a contribution and a distribution, the contributing partner generally will be subject to the entrepreneurial risks and rewards of partnership operations – the hallmark of “partner” status. If, however, little time elapses before the contributor is “cashed out,” the contributor will not be subject to such risks and rewards. In contrast, the time period that elapses between a contribution and a distribution has no relevance to whether the contributing partner will be, or the distributee partner has been, subject to the entrepreneurial risks and rewards of partnership operations.

If, however, the IRS and Treasury choose to include timing presumptions in the Interest Regulations, we believe that, for the sake of consistency, the two-year presumptions of

\begin{itemize}
  \item \textsuperscript{62} Treas. Reg. § 1.707-3(d).
  \item \textsuperscript{63} \textit{Id.}
  \item \textsuperscript{64} The House Report, at 1221 (emphasis added); the Senate Report, at 231 (emphasis added).
  \item \textsuperscript{65} Treas. Reg. §§ 1.707-3(c)(2) and -8 provide that a taxpayer must disclose transfers made within two years if such transfers meet the definition of a disguised sale of property and the transfer of money or other consideration to the partner is not a guaranteed payment for capital under Treas. Reg. § 1.707-4(a)(1)(ii), a reasonable preferred return within the meaning of Treas. Reg. § 1.707-4(a)(3), or an operating cash flow distribution within the meaning of Treas. Reg. § 1.707-4(b)(2). \textit{See also} Treas. Reg. § 1.707-5(a)(7)(ii) (requiring that a taxpayer must disclose transfers made within two years if such transfers meet the definition of a disguised sale of property and a partner treats a liability assumed or taken subject to by the partnership as a non-anticipatory liability under Treas. Reg. § 1.707-5(a)(6)(i)(B)); Treas. Reg. § 1.707-6(c) (providing a similar rule in disguised sales of property by the partnership to a partner).
\end{itemize}
the Property Regulations should be utilized. There is no indication as to the origin of the two-
year time period in either the preamble to the proposed Property Regulations or to the final
Property Regulations. Nevertheless, to the extent that a reasoned policy judgment was made to
apply the two-year presumptions to the Property Regulations, such judgment is presumably
equally applicable to the Interest Regulations.

4. The Interest Regulations Should Include
   Certain Safe Harbors From the Property Regulations

The Property Regulations provide that certain distributions will not be considered
to be disguised sale proceeds. These “safe harbor” distributions include certain guaranteed
payments, preferred returns, operating cash flow distributions, and reimbursement of
preformation expenditures. We suggest that the safe harbor distributions of the Property
Regulations be included in the Interest Regulations. Moreover, we believe the IRS and Treasury
should take the opportunity to improve the definition of “operating cash flow distributions” (as
set forth in Treas. Reg. § 1.707-4(b)(2)(i)) to include partnership taxable income or loss resulting
from sales other than in the ordinary course of the partnership’s business. Finally, we believe
that the Interest Regulations should include (and the Property Regulations should be amended to
include) safe harbors for distributions that are intended to satisfy a distributee’s liability for
income taxes incurred as a result of an allocation of income to the distributee.

B. The IRS Should Include Additional
   Safe Harbors in the Interest Regulations

To promote certainty and administrative convenience, we suggest that the IRS
and Treasury provide specific protective safe harbors under the Interest Regulations for
particular commonplace transactions that should not be treated as sales of partnership interests
under the double but for test.

An example of such commonplace transactions involves partners in service
partnerships. Many service partnerships admit new partners annually, often requiring significant
capital contributions, and partners retire from these partnerships annually, taking their capital
with them. As a result, these partnerships have contributions and distributions that occur within
relatively short time periods, often within the same tax year. Yet, other than the fact that such
contributions and distributions are often (nearly) contemporaneous, such transactions bear no
similarity to a sale. Most service partnerships grow each year. Thus, contributions by new
partners are intended to increase the size of the partnership. Moreover, the contributors would
make such contributions regardless of whether another partner reached retirement age or
otherwise left the partnership. Thus, it seems clear that contributions to and distributions from
service partnerships would not satisfy the double but for test.

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66 We are mindful, however, of Emerson’s admonition. See Ralph Waldo Emerson, Self-Reliance (1841) (“A
   foolish consistency is the hobgoblin of little minds…”).

67 See the preamble to the proposed Property Regulations, 56 Fed. Reg. 19,055; preamble to the Property

In addition, it would be unduly burdensome to treat commonplace contributions to and distributions from service partnerships as part of disguised sales of partnership interests. As discussed above, service partnerships frequently receive contributions from new partners and frequently make distributions to retiring partners. Due to the frequency and volume of such contributions and distributions, it may be difficult to determine which retiring partners would be considered to have sold interests to which new partners. For these reasons, we believe that the IRS and Treasury should establish a safe harbor in the Interest Regulations for routine contributions to and distributions from service partnerships (e.g., partnerships providing legal, accounting, architectural, consulting, or medical services).

Another safe harbor should be provided for securities partnerships. Many securities partnerships admit new partners after the formation of the partnership and entirely or partially redeem the interests of other partners. Our experience is that the admission of a new partner to these partnerships typically is unrelated, as a factual matter, to the partial or complete redemption of another partner. Therefore, such contributions and distributions would not satisfy the double but for test. Accordingly, we believe that the IRS and Treasury should provide a safe harbor for routine contributions to and distributions from securities partnerships.

Similarly, we suggest that a safe harbor be provided for staged closings in syndicated offerings. In staged closings, a developer will often receive investments from partners at different times, or in stages. In many instances, partners who invested in earlier stages will receive distributions that are funded from contributions from partners who invest in later stages. Such distributions are most properly viewed as being in the nature of an adjustment to (and refund of) the early investors’ capital contributions. In addition, because staged closings generally occur over a short period of time, the potential for appreciation is relatively de minimis, and, thus, the potential for tax abuse is not material. Finally, in our experience, the parties view staged closings as purely an administrative convenience. If these transactions were treated as sales transactions, it would perhaps be possible to wait to close the offering until all investors had subscribed, but this would be done solely to avoid an adverse tax result. To avoid imposing distortions on real, economically motivated transactions where there is little potential for tax abuse, we believe that the IRS and Treasury should provide a safe harbor exception for partnerships involved in staged closings.

To the extent that other situations arise in which the IRS and Treasury feel that a safe harbor would promote certainty and administrative convenience, the IRS and Treasury should retain the flexibility to provide additional safe harbor exceptions under the Interest Regulations in public guidance similar to the manner in which the IRS and Treasury may provide safe harbor exceptions under the Property Regulations.69

69 Treas. Reg. § 1.707-4(e) (providing that the IRS may provide, by guidance published in the Internal Revenue Bulletin, that certain payments or transfers to a partner are not treated as part of a disguised sale of property).
C. The Interest Regulations Should Provide Examples of the Regulations’ Application

In its simplest form, a disguised sale of a partnership interest involves a contribution and a distribution that are dependent upon each other and are documented as part of the same transaction. Because transactions that may be characterized as sales of partnership interests will rarely be structured in such a simple manner, we recommend the IRS and Treasury provide a number of examples illustrating the proper application of the Interest Regulations.

1. Distributions of Money in Complete Redemption of a Partner’s Interest

As was discussed above, if a partner exchanges his entire interest for cash, the partner will recognize all of his gain (or loss) regardless of whether that partnership interest is redeemed for a cash distribution or whether the partner sells his partnership interest to another partner. (As was noted above, however, there may be different treatment under sections 734(b) and 743(b), and sections 751(a) and 751(b).) Therefore, a cash distribution resulting in the complete redemption of a partner’s interest offers little opportunity for tax abuse. Nevertheless, if such a distribution is part of a transaction that satisfies the double but for test, the transaction would be treated as a sale of a partnership interest. The following example illustrates this principle:

Example 1. A, B, and C are partners in the ABC partnership, which is worth $10 million (the combined assets of the partnership have a fair market value of $10 million). A owns a 40 percent, and B and C each owns a 30 percent, interest in the profits, losses, and capital of the partnership.

D wants to buy A’s partnership interest. A and D, with the partnership’s cooperation, decide to structure the transaction as a contribution and distribution transaction. D contributes $4 million in cash to the partnership.

Without a distribution to A, D would be admitted as a 28.6 percent partner, A would own a 28.6 percent interest, and B and C would each own 21.4 percent interests. As part

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70 If the transaction is respected as a contribution and subsequent distribution, the rules of section 734(b) will apply, rather than those of section 743(b). Notably, applying the rules of section 734(b) will generally result in a less favorable result for the contributing partner than if the contributing partner had instead purchased an interest and obtained a positive basis adjustment with respect to the partnership’s assets under section 743(b).

71 We note that there may be differences between sections 751(a) and (b). While we believe that the IRS and Treasury should minimize such apparent differences in formal guidance, the different treatment under sections 751(a) and (b) should not be sufficient reason to prevent an exception under the Interest Regulations for transactions involving complete redemptions. Formal guidance with respect to section 751 is forthcoming. See Office of Tax Policy and Internal Revenue Service, 2003-2004 Priority Guidance Plan, 2003 TNT 143-7 (July 25, 2003).

72 For simplicity, none of the partnerships in the examples in this comment letter own any unrealized receivables or inventory items within the meaning of section 751(c) and (d) (“hot assets”).

73 The characterization of the transaction as a sale would not change if D contributed property other than cash to the partnership, so long as such property was distributed to A in complete redemption of A’s partnership interest.
of a plan to increase D’s interest to 40 percent (simultaneously keeping B and C’s interests at 30 percent), the cash is immediately distributed to A in complete redemption of A’s interest. The contribution would not have been made but for the distribution, and the distribution would not have been made but for the contribution.

This transaction has all of the basic characteristics of a disguised sale of a partnership interest. A starts as a 40 percent partner. When the transaction is completed, D owns a 40 percent interest, and A’s partnership interest has been reduced to zero. A receives a distribution equal to the fair market value of his partnership interest. This transaction satisfies the double but for test. There has been (i) a contribution of money or other property to the partnership resulting in an increase in D’s partnership interest, (ii) a distribution of money or other property by the partnership to A resulting in a corresponding decrease in A’s partnership interest, and (iii) the contribution would not have been made but for the distribution, and the distribution would not have been made but for the contribution. Because the double but for test is satisfied, the transaction should be treated as a sale of a partnership interest.

We believe that this transaction should be treated as a disguised sale of a partnership interest. Nevertheless, as such transactions present little opportunity for tax abuse, the IRS and Treasury may wish, as a matter of administrative convenience, to consider creating an exception from the Interest Regulations for complete redemptions in exchange for cash.

2. Distributions in Partial Redemption of a Partner’s Interest

The issue of whether a transaction should be treated as a disguised sale of a partnership interest becomes more important if the transaction does not involve the complete redemption of a partnership interest. The following example illustrates a disguised sale that involves a partial redemption of a partner’s interest:

Example 2. A, B, and C are partners in the ABC partnership, which is worth $10 million (the combined assets of the partnership have a fair market value of $10 million). A owns a 40 percent, and B and C each owns a 30 percent, interest in the profits, losses, and capital of the partnership.

D wants to buy a portion of A’s partnership interest. A and D, with the partnership’s cooperation, decide to structure the transaction as a contribution and distribution transaction. D contributes $1 million in cash to the partnership. Without a distribution to A, D would be admitted as a 9 percent partner, A would own a 36.4 percent interest, and B and C would each own 27.3 percent interests. As part of a plan to increase D’s interest to 10 percent (simultaneously keeping B and C’s interests at 30 percent), the cash is immediately distributed to A, reducing A’s interest to 30 percent. The distribution would not have been made but for the contribution, and the contribution would not have been made but for the distribution.

This transaction has all of the basic characteristics of a disguised sale of a 10 percent partnership interest. A starts as a 40 percent partner. When the transaction is completed,
D owns a 10 percent interest, and A’s partnership interest is reduced to 30 percent. A receives a
distribution equal to the fair market value of the partnership interest that has been “redeemed.”
This transaction satisfies the double but for test. There has been (i) a contribution of money or
other property to the partnership resulting in an increase in D’s partnership interest, (ii) a
distribution of money or other property by the partnership to A resulting in a corresponding
decrease in A’s partnership interest, and (iii) the contribution would not have been made but for
the distribution, and the distribution would not have been made but for the contribution.
Because the double but for test is satisfied, the transaction should be treated as a sale of a
partnership interest.

3. Contribution and Distribution of Different Property

A contribution and distribution transaction could involve the contribution of
property by one partner and the distribution of different property to another partner. On its face,
this transaction has the basic characteristics of a disguised sale of a partnership interest.

Example 3. A, B, and C are partners in the ABC partnership, which is
worth $10 million (the assets of ABC consist of Property X, a building that has a
fair market value of $4 million and an adjusted basis of $1 million, and Property
Y, which has a fair market value of $6 million and an adjusted basis of $2
million). A owns a 40 percent, and B and C each owns a 30 percent, interest in
the profits, losses, and capital of the partnership. A’s basis in his partnership
interest is $1 million.

D owns Property Z, intellectual property that has a fair market value of $4
million and an adjusted basis of $3 million. D contributes Property Z to the
partnership in exchange for a 40 percent interest in the partnership, and the
partnership distributes Property X to A. D is admitted as a 40 percent interest
partner, and A’s partnership interest is completely redeemed. There were no
negotiations between A and D. Nevertheless, D would not have made the
contribution but for the distribution to A, and the partnership would not have
made the distribution to A but for the contribution by D.

Once again, this transaction has all of the basic characteristics of a disguised sale
of a partnership interest. A starts as a 40 percent partner. When the transaction is completed, D
owns a 40 percent interest, and A’s partnership interest is reduced to zero. A receives a
distribution equal to the fair market value of his partnership interest. This transaction satisfies
the double but for test. There has been (i) a contribution of money or other property to the
partnership resulting in an increase in D’s partnership interest, (ii) a distribution of money or
other property by the partnership to A resulting in a corresponding decrease in A’s partnership
interest, and (iii) the contribution would not have been made but for the distribution, and the
distribution would not have been made but for the contribution.

Although this transaction would satisfy the double but for test, we do not believe
that this transaction should be treated as a sale of a partnership interest. As was discussed above,
it is clear from the legislative history of section 707(a)(2)(B) that the disguised sale rules were
intended to recharacterize transactions that are, in substance, sales. The substance of the
transaction in Example 3 aligns with its form, and the form of the transaction is the most logical explanation for what occurred. That is, any recharacterization would require extra steps that did not occur in the original transaction and would be a complete departure from the economic realities of the transaction.

Indeed, it is unclear how the transaction would be recharacterized, because at least two different alternatives exist. In one alternative, D would be treated as having transferred Property Z to ABC in exchange for Property X. D would recognize gain of $1 million on the exchange, 74 taking Property X with a basis equal to its cost of $4 million. 75 ABC would recognize gain of $3 million on the exchange 76 and would allocate the $3 million of gain recognized on the exchange of Property X to its partners. Thus, A’s adjusted basis in its partnership interest would increase from $1 million to $2.2 million. Subsequently, D would transfer Property X to A in exchange for A’s partnership interest. D would recognize no gain on the exchange, 77 but A would recognize $1.8 million of gain. 78

In an alternative recharacterization, D would be treated as having sold Property Z to A in exchange for A’s partnership interest. In that case, D would recognize gain of $1 million, 79 and A would recognize gain of $3 million. 80 Subsequently, A would be treated as having exchanged Property Z with the partnership in exchange for Property X, resulting in the recognition of $3 million of gain 81 by the partnership, which would be allocated to the partners. Unless the partnership had a section 754 election in effect for the year in which D acquired its interest, D would include in its income its distributive share of this gain. 82 Clearly, under either of the two alternative recasts, extra steps would need to be constructed.

The creation of steps and the unanticipated tax consequences to the other partners that may result seem inappropriate in light of Congress’s narrow concern regarding disguised sales of partnership interests. Under the step transaction doctrine (and related doctrines), the IRS

75 Section 1012.
76 The partnership’s amount realized of $4 million (the fair market value of Property Z) minus the partnership’s adjusted basis of $1 million in Property X.
77 D’s amount realized of $4 million (the fair market value of A’s Interest) minus D’s adjusted basis of $4 million in Property X.
78 A’s amount realized of $4 million (the fair market value of Property X) minus A’s outside basis of $2.2 million.
79 D’s amount realized of $4 million (the fair market value of A’s interest) minus D’s adjusted basis of $3 million in Property Z.
80 A’s amount realized of $4 million (the fair market value of Property Z) minus A’s outside basis of $1 million.
81 The partnership’s amount realized of $4 million (the fair market value of Property Z) minus the partnership’s adjusted basis of $1 million in Property X.
82 This seems to be a particularly harsh result.
generally may not reorder steps of a transaction, much less create additional steps. Moreover, it would seem that the creation of collateral taxable steps in addition to the recharacterization of a transaction as a sale of a partnership interest would exceed Congress’s narrow focus, if not the regulatory authority granted to the IRS and Treasury. It simply seems a bit far fetched to say that a transaction such as the one described in Example 3 is more properly treated as a sale of a partnership interest than as a contribution and unrelated distribution.

In each alternative recharacterization discussed above, even though their percentage interests have not changed, B and C are allocated a share of the gain recognized upon the sale of Property X by the partnership. It may be argued that B and C should recognize gain because B and C have relinquished their interests in Property X and acquired interests in Property Z. Nevertheless, such a result is contrary to the fundamental operation of subchapter K. When a partnership distributes property to a partner in complete or partial redemption of the partner’s interest, the remaining partners’ interests in the partnership’s remaining assets increases. The relinquishment of the remaining partners’ interests in the distributed property “in exchange” for their increased interests in the partnership’s remaining assets does not result in taxation (except as provided in section 751(b)). Similarly, when a partner contributes property to a partnership, the historic partners’ interests in the partnership’s historic assets decreases, and their interests in the contributed asset increases. The relinquishment of the historic partners’ interests in the partnership’s historic assets “in exchange” for their increased interests in the contributed property does not result in taxation. There is simply no evidence that, in enacting section 707(a)(2)(B), Congress intended to alter fundamentally subchapter K. Indeed, as has been discussed above, Congress’s express intention was to target a narrow range of abusive transactions.

Consistent with this intention, we believe that transactions such as those described in Example 3 should not be treated as sale transactions. Moreover, we do not suggest that it should be permissible to use a partnership to facilitate a negotiated exchange of property between A and D. If, prior to D’s contribution and the distribution to A, A had negotiated with D for an exchange of A’s partnership interest for Property Z and had subsequently negotiated with the partnership for an exchange of Property Z for Property X, the transaction would be subject to recharacterization as a sale of a partnership interest under the double but for test.

83 Esmark, Inc. v. Commissioner, 90 T.C. 171, at 196 (1988), aff’d without opinion, 886 F.2d 1318 (7th Cir. 1989). See also Grove v. Commissioner, 490 F.2d 241 (2nd Cir. 1973) (denying the IRS’s attempt to recast a gift/redemption transaction as a redemption/gift transaction by reversing the steps; stating that “[u]seful as the step transaction doctrine may be in the interpretation of equivocal contracts and ambiguous events, it cannot generate events which never took place just so an additional tax liability might be asserted”); Tracinda Corp. v. Commissioner, 111 T.C. 315 (1998) (in denying the IRS’s attempt to recast a series of mutually dependent simultaneous sales transactions as a contribution to capital and subsequent redemption, the court stated that the IRS cannot create fictional steps that have not occurred).

84 Section 731(b).
85 Section 721(a).
86 See Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971) (distribution of real property was treated as part of a disguised sale of a partnership interest because, as part of a pre-arranged plan to sell the distributee’s partnership interest for cash, the distributee transferred the real property in a like-kind exchange to her husband’s estate, which later sold the real property for cash to a partner in the partnership, who then contributed the real
there was neither a formal nor informal agreement between A and either D or the partnership, however, the transaction above should not be considered to be a disguised sale of a partnership interest.

4. Contribution By Current Partner, Distribution to Another Current Partner

A disguised sale of a partnership interest can involve a contribution by an existing partner and a distribution to another partner. Such a situation should be treated no differently than a contribution by a new partner. The following example illustrates this situation:

Example 4. A, B, and C are partners in the ABC partnership, which is worth $10 million (the combined assets of the partnership have a fair market value of $10 million). A owns a 40 percent, and B and C each owns a 30 percent, interest in the profits, losses, and capital of the partnership.

C contributes $1 million in cash to the partnership. Without a distribution to another partner, C’s interest in the partnership would be increased to 36.4 percent, A’s interest would be reduced to 36.4, and B’s interests would be reduced to 27.2 percent. As part of a plan to increase C’s interest to 40 percent (simultaneously keeping B’s interest at 30 percent), however, the cash is immediately distributed to A, reducing A’s interest to 30 percent. The distribution to A would not have been made but for the contribution by C, and the contribution by C would not have been made but for the distribution to A.

This transaction has all of the basic characteristics of a disguised sale of a 10 percent partnership interest. A starts as a 40 percent partner. C owns a 40 percent interest, and A receives a distribution that reduces his partnership interest to 30 percent. This transaction satisfies the double but for test. There has been (i) a contribution of money or other property to the partnership resulting in an increase in C’s partnership interest, (ii) a distribution of money or other property by the partnership to A resulting in a corresponding decrease in A’s partnership interest, and (iii) the contribution would not have been made but for the distribution, and the distribution would not have been made but for the contribution. The transaction should be treated as a sale of a partnership interest.

5. Pro Rata Contributions

A disguised sale of a partnership interest can take the form of pro rata contributions by all but one current partner to the partnership and a contemporaneous distribution to the noncontributing partner. We believe that this transaction should be treated as

property back to the partnership). See also Commissioner v. Court Holding Co., 324 U.S. 331 (1945) (after a corporation negotiated the sale of a building with a prospective buyer, the shareholders (i) liquidated the corporation and received the building in liquidation of their interests, and (ii) later engaged in the sale on substantially similar terms with the same buyer; the Court ruled that the corporation, rather than the shareholders, was the true seller of the building).
a sale of a partnership interest if the transaction otherwise satisfies the double but for test. This transaction is illustrated in the following example:

**Example 5.** A, B, and C are partners in the ABC partnership, which is worth $10 million (the combined assets of the partnership have a fair market value of $10 million). A owns a 40 percent, and B and C each owns a 30 percent, interest in the profits, losses, and capital of the partnership.

B and C each contribute $500,000 in cash to the partnership. Without a distribution to A, B’s and C’s interests would be increased to 31.8 percent each. As part of a plan to increase B’s and C’s interests in the partnership to 35 percent each, the cash is immediately distributed to A, and A is reduced to a 30 percent partner. The distribution to A would not have been made but for the contributions by the other partners, and the contributions by the other partners would not have been made but for the distribution to A.

This transaction has all of the basic characteristics of a disguised sale of a 10 percent partnership interest. A starts as a 40 percent partner. When the transaction is completed, B and C each own a 35 percent interest, and A has received a distribution that reduces his partnership interest to 30 percent. This transaction satisfies the double but for test. There has been (i) a contribution of money or other property to the partnership resulting in an increase in B’s and C’s partnership interests, (ii) a distribution of money or other property by the partnership to A resulting in a corresponding decrease in A’s partnership interest, and (iii) the contributions would not have been made but for the distribution, and the distribution would not have been made but for the contributions. This transaction should be treated as a sale of a partnership interest.

6. **A Capital Contribution With Respect to a Defaulting Partner Should Not Be Considered a Disguised Sale of a Partnership Interest**

Partnership agreements frequently contain provisions that adjust partnership interests when one partner (a “nondefaulting partner”) makes a capital contribution required to be made by another partner (a “defaulting partner”). These provisions typically adjust interests in partnership profits. On occasion, such adjustments have the effect of transferring unrealized appreciation between partners. Additionally, such provisions occasionally involve the transfer of “book” capital between partners. None of these transactions should be treated as disguised sales of partnership interests between partners because they do not involve distributions to a partner, thus failing one of the prongs of the double but for test.\(^\text{87}\)

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\(^{87}\) Some practitioners believe there is a risk that such a shift of unrealized or realized book capital is taxable. It is clear that not all capital shifts are taxable. See REG-103580-02, Notice of Proposed Rulemaking, Noncompensatory Partnership Options, 68 Fed. Reg. 2,930 (Jan. 22, 2003) (making clear that capital shifts occurring in connection with the exercise of an option or a conversion right is not taxable). We believe that a capital shift in the circumstances described in the text is not an appropriate time to impose income tax.
D. Special Rules Relating to Liabilities

The legislative history underlying section 707(a)(2)(B) explains that Congress anticipated that the disguised sale provisions would apply if (i) a transferor partner received the proceeds of a loan related to contributed property and responsibility for the repayment of the loan rested with the partnership or the other partners, or (ii) the partner obtained a loan related to the property in anticipation of the transaction and responsibility for repayment of the loan was transferred to the partnership or the other partners. The common concern is whether the relief of liability involves a shift of economic benefits and burdens.

1. The Allocation or Reallocation of Partnership Liabilities Under Section 752 Generally Should Not Be Treated as a Disguised Sale of a Partnership Interest

Under section 752(a), an increase in a partner’s share of partnership liabilities is treated as a contribution of money to the partnership by that partner. Conversely, under section 752(b), a decrease in a partner’s share of partnership liabilities is treated as a distribution of money to the partner. Although deemed contributions or distributions could fit within the framework of a disguised sale of a partnership interest, we believe that such deemed contributions and distributions are irrelevant to the extent they are primarily non-economic events.

Deemed contributions and distributions resulting from the mere allocation or reallocation of partnership liabilities do not affect the primary economic responsibilities of the partners with respect to liabilities of the partnership. Rather, their purpose is to create basis parity in subchapter K. This should be contrasted with deemed contributions and distributions that result from an actual assumption of a liability. When one person actually assumes another’s liability, the assumption is in every meaningful sense the economic equivalent of a transfer of money to the person whose liability has been assumed. Only the actual assumption of a liability can be part of a disguised sale of a partnership interest.

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88 The House Report, at 1221; the Senate Report, at 231.
89 Of course, liabilities can be allocated or reallocated under section 752 to reflect the partners’ “economic risk of loss” with respect to the liabilities. Treas. Reg. § 1.752-2(a). This risk of loss, however, always represents risk of loss in the sense that a partner is an indemnitor or guarantor, for if a liability is a partnership-level liability, the partnership necessarily has primary responsibility for the liability.
90 See, e.g., Treas. Reg. § 1.1001-2 (in general, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or other disposition).
91 If a partnership interest is sold, the transferor’s allocable share of partnership liabilities is included in her amount realized under sections 752(d) and 1001. See Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793 (1988) (in a transaction in which three shareholders of a corporation assumed liabilities associated with the partnership interest owned by the corporation in exchange for the corporation’s partnership interest, the transaction was treated as a sale of the partnership interest rather than a contribution by the shareholders to the partnership and a distribution to the corporation from the partnership; section 311 did not apply because the parties stipulated that the corporation did not distribute its partnership interest to the shareholders).
The disguised sale of partnership interest inquiry fundamentally seeks to determine whether a contribution and related distribution economically resemble a sale of a partnership interest. As discussed above, Congress did not intend for “liability transactions” to be recharacterized unless the relief of liability involved a shift of economic benefits and burdens. The Senate Report provides:

[T]he committee does not intend to change the general rules concerning the tax treatment of the partners under sections 721, 731, and 752 to the extent … contributions to a partnership which, because of liabilities of the partnership incurred other than in anticipation of the contribution[,] result in a deemed distribution under sec. 752(b).92

It seems that Congress recognized the difference between constructive contributions or distributions resulting from the mere allocation or reallocation of partnership liabilities and contributions and distributions that result from an actual assumption of a liability.

Not only does the legislative history underlying section 707(a)(2)(B) support distinguishing between non-economic and economic debt shifts, the distinction is also drawn in the Property Regulations. In those regulations, the assumption by a partnership or a partner of liabilities may give rise to a disguised sale.93 The mere allocation or reallocation of liabilities under section 752 cannot.94

The section 704(b) regulations draw the same distinction. Under those regulations, the allocation or reallocation of liabilities under section 752 does not impact the partner’s capital accounts,95 which measure the partners’ economic entitlement to partnership property. Instead, only an assumption of a liability will cause an adjustment to a partner’s capital account.96 The regulations under section 1223 draw the same distinction between the

92 The Senate Report, at 230.
94 In determining the extent to which a partnership assumes or takes property subject to a liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner’s share of that liability immediately after the partnership’s assumption. Id. Significantly, the partner’s share of the liability is reduced in situations in which the liability is allocated in a manner that avoids disguised sale treatment, the liability is subsequently reallocated, the reallocation is anticipated at the time the liability is assumed, and the allocation is part of a plan to avoid a disguised sale. Treas. Reg. § 1.707-5(a)(3). See Treas. Reg. § 1.707-5(b)(2)(iii) for a similar rule in determining the partner’s share of the liability incurred in a debt-financed distribution.
95 Treas. Reg. § 1.704-1(b)(2)(iv)(c). If a partner contributes property to a partnership or a partnership distributes property to a partner, in both cases with associated debt, only the net fair market value of the property is credited to or debited from the partner’s capital account. Treas. Reg. § 1.704-1(b)(2)(iv)(b).
96 Id.
allocation or reallocation of partnership liabilities under section 752 and the actual assumption of a liability (section 1223 determines the holding period for a partnership interest).  

The IRS, in published guidance, has taken the same approach. In Rev. Rul. 84-102, three partners each owned one-third interests in a partnership. The partnership had $100 of liabilities and $40 of unrealized receivables within the meaning of section 751(c). The ruling provides that, upon the admission of a fourth partner, the fourth partner acquired a 25 percent interest in the partnership’s unrealized receivables and the partnership’s liabilities. The reallocation of liabilities resulted in a constructive contribution by the fourth partner and a corresponding constructive distribution to the three historic partners. The ruling concludes that each of the original partners was required to recognize ordinary income under section 751(b)(1)(B) on the reduction of each partner’s share in unrealized receivables.

Because there was a contribution by the fourth partner, resulting in an increase in his partnership interest, and a constructive distribution to the three historic partners, resulting in decreases in their partnership interests, the transaction in Rev. Rul. 84-102 could have been treated as a disguised sale of a partnership interest. Significantly, the ruling concludes that section 751(b), not sections 741 and 751(a), is implicated by the transaction. If the transaction had been a disguised sale of a partnership interest, sections 741 and 751(a) would have been applicable. Thus, it seems that the drafters of the ruling believed that the reallocation of partnership liabilities was not properly viewed as consideration in a sale transaction.

In summary, the mere allocation or reallocation of partnership liabilities does not affect the primary economic responsibilities of the partners with respect to liabilities of the partnership. As a result, such allocation or reallocation should not be considered to constitute consideration exchanged in a sale of a partnership interest. This principle has been repeatedly adopted by the IRS and Treasury in regulations and endorsed by Congress in the legislative history to the disguised sale rules. Accordingly, we believe that the Interest Regulations should provide that the mere allocation or reallocation of partnership liabilities under section 752 will not be treated as part of a disguised sale of a partnership interest.

2. Debt-Financed Distributions Generally Should Not Be Treated as Part of a Disguised Sale of a Partnership Interest

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97. Treas. Reg. § 1.1223-3(b)(3) (providing that, for purposes of determining the holding period for a partnership interest, deemed contributions and distributions under section 752 are disregarded to the same extent they are disregarded under Treas. Reg. § 1.704-1(b)(2)(iv)(c)).

98. 1984-2 C.B. 119. For a discussion of the shortcomings of this ruling, see Monte A. Jackel and Avery I. Stok, Blissful Ignorance: Section 751(b) Uncharted Territory, 98 TAX NOTES 1557, 1564 (Mar. 10, 2003).

99. See supra Background, Section II, E.

100. Rev. Rul. 84-102 was issued in July of 1984, well after the litigation in Communications Satellite Corp. and Jupiter Corp. and very close in time to the enactment of section 707(a)(2)(B), also in July of 1984. Thus, it is clear that, at the time the revenue ruling was published, the IRS, Treasury, and Congress were aware of and carefully studying the issues relating to disguised sales of partnership interests.
The Conference Committee Report on section 707(a)(2)(B) (the “Conference Report”) specifically directed that the disguised sale provisions would not apply if the partner retained liability for repayment of the debt, because “to the extent the other partners have no direct or indirect risk of loss with respect to such amounts …, in effect, the partner has simply borrowed through the partnership.”

Accordingly, the IRS and Treasury provided relatively taxpayer-favorable provisions in the Property Regulations relating to assumption of debt and debt-financed distributions. In one such provision, the Property Regulations provide that, if a partnership transfers money within ninety days of incurring a liability and the transfer is allocable to such liability, the amount transferred from the partnership that may be treated as part of a disguised sale is reduced by the partner’s share of the liability that is allocable to the money transferred to the partner. This debt-financed distribution exception, which is responsive to congressional intent, preserves the ability of the partners to receive debt-financed distributions taxable under the normal operating rules of subchapter K, rather than under section 707(a)(2)(B). For the same reasons that such an exception is appropriate in the Property Regulations, we believe it is appropriate for the Interest Regulations to include a debt-financed distribution exception. As disguised sales of partnership interests arise in a different context from disguised sales of property, the rules regarding debt-financed distributions in the Interest Regulations will, of course, differ from the rules in the Property Regulations. The following discussion illustrates the manner in which we believe those rules should function.

a. Debt-Financed Distributions Generally

Partnerships routinely borrow to fund a distribution to a retiring partner. Under section 752, to the extent that the liability is allocated to the continuing partners, those partners are treated as making contributions of money to the partnership. Such a transaction should not be considered to be part of a disguised sale of a partnership interest.

Example 6. A and B are partners in the AB partnership, which is worth $12 million (the combined assets of the partnership have a fair market value of $12 million). A and B each owns a 50 percent interest in the profits, losses, and capital of the AB partnership.

A and B agree to reduce A’s interest in the partnership to 25 percent and increase B’s interest to 75 percent. The partnership borrows $4 million, recourse to all of the assets of the partnership, but nonrecourse to the partners, and distributes the $4 million to A, reducing A’s interest in the partnership to 25 percent.

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102 See Treas. Reg. § 1.707-5(b). A partner’s allocable share of a liability is determined by multiplying the partner’s share of the liability under Treas. Reg. § 1.707-5(a)(2) by a fraction, (i) the numerator of which is the portion of the liability that is allocable under Treas. Reg. § 1.163-8T to the money or other property transferred to the partner, and (ii) the denominator of which is the total amount of the liability. Treas. Reg. § 1.707-5(b)(2).
103 Section 752(a).
This transaction should not be treated as satisfying the double but for test because, as was discussed above, the mere allocation of liabilities under section 752 does not result in an economic contribution by a partner and, therefore, should not be treated as creating or being a part of a disguised sale of a partnership interest.

b. **Debt-Financed Distribution with Guarantee**

The result in Example 6 above should not be different simply because of the existence of a guarantee by one of the partners. For example, if a partnership is able to borrow to fund a distribution to a retiring partner, but one of the partners guarantees the loan to permit the partnership to obtain more favorable financing terms, the transaction should not be treated as a contribution by the guaranteeing partner that would give rise to sale treatment.

**Example 7.** A and B are partners in the AB partnership, which is worth $12 million (the combined assets of the partnership have a fair market value of $12 million). A and B each owns a 50 percent interest in the profits, losses, and capital of the AB partnership.

A and B agree to reduce A’s interest in the partnership to 25 percent and increase B’s interest to 75 percent. Creditors agree to lend $4 million to the partnership based solely upon the partnership’s creditworthiness. If B guarantees the debt, however, the partnership will obtain a lower interest rate on the debt. Accordingly, the partnership borrows $4 million, and B guarantees the debt. The partnership distributes the $4 million to A, reducing A’s interest in the partnership to 25 percent.

B’s guarantee of the debt causes the debt to be allocated to B under Treas. Reg. § 1.752-2(a). Under Treas. Reg. § 1.752-1(b) and section 752(a), B is treated as contributing $4 million to the partnership.

This transaction should not result in any different consequences than those of Example 6. B did not guarantee the liability to affect a transfer of consideration to A, but rather simply to allow the partnership to obtain more favorable financing terms. Thus, the debt should be considered partnership-level debt, and the transaction should not be recharacterized as a disguised sale of a partnership interest.

Of course, to the extent that a liability is not the debt of the partnership and is instead properly treated as the debt of an individual partner for tax purposes, such a transaction should be characterized in accordance with general federal income tax principles. In such a case,

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104 See *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), aff’g 29 T.C.M. 817 (1970) (in a case in which a corporation could not have borrowed without the guarantee of its shareholder, shareholder treated as true borrower for tax purposes).
for example, the guaranteeing partner might be treated as contributing cash to the partnership,\(^{105}\) which contribution could satisfy one prong of the double but for test and lead to sale treatment.

c. **Debt-Financed Distribution with New Contribution**

A partnership could distribute the proceeds of a partnership borrowing in retirement of a partner and contemporaneously receive a capital contribution from a new or existing partner. This transaction could be characterized as a disguised sale of a partnership interest if the double but for test is satisfied.

**Example 8.** A, B, and C are partners in the ABC partnership, which is worth $10 million (the combined assets of the partnership have a fair market value of $10 million). A owns a 40 percent, and B and C each owns a 30 percent, interest in the profits, losses, and capital of the partnership.

To fund a distribution to A, the partnership intends to borrow $2 million. Corporation X owns Property, which has a fair market value of $2 million. In a simultaneous closing, X contributes Property to the partnership for use in the partnership’s business in exchange for a 20 percent interest in the partnership, the partnership borrows $2 million, recourse to all of the assets of the partnership, but nonrecourse to the partners, and distributes the $2 million in cash to A. X is admitted as a 20 percent interest partner, and A’s interest is reduced to 20 percent.

As was discussed above, the Interest Regulations were not intended to and should not interfere with the partners’ ability to borrow through the partnership (i.e., borrow against the assets of the partnership). The determination of whether such a debt-financed distribution and contemporaneous contribution should, consistent with congressional intent, focus on (i) whether the partners have “simply borrowed through the partnership,”\(^{106}\) in which case the form of the transaction should be respected, or (ii) whether the partnership has merely acted as a conduit for the transfer of funds between the “purchasing” partner and the “selling” partner, in which case the transaction should be treated as a sale. The answer to this inquiry should depend upon whether the liability is debt of an individual partner, rather than partnership-level debt.

In Example 8, X contributes Property to the partnership, which is used in the partnership’s business. Thus, Property is an asset of the partnership. Similarly, the liability is a partnership-level liability. Because the partnership was not used as a conduit to transfer funds from X to A, the transaction in Example 8 should not be treated as a sale.

The fact that Property may support the liability in Example 8 is not relevant to the determination of whether the transaction is a disguised sale of a partnership interest. Under the Property Regulations, a partner may receive a debt-financed distribution supported by property of the partnership other than property such partner contributed to the partnership (regardless of

\(^{105}\) See id. (where purportedly entity-level loan is treated as shareholder borrowing, shareholder is treated as contributing the proceeds of the loan to the capital of the corporation).

\(^{106}\) To quote the Conference Report, *supra* note 101.
whether the property was newly-contributed to the partnership), as long as the distribution does not exceed the distributee partner’s allocable share of the debt.\(^\text{107}\) For the same reasons that the Property Regulations permit the use of contributed property to support a debt-financed distribution, the Interest Regulations should provide a similar rule.

In many cases in which the contemporaneous contribution is in the form of cash, and cash is used to satisfy an existing partnership liability, it may be difficult to determine whether the partnership has merely acted as a conduit – distributing the contributed cash – or distributed the proceeds of a new borrowing and used the contributed cash to retire existing partnership liabilities. We believe that, in such a case, to the extent that the liability that is satisfied with the contributed funds is “non-anticipatory,” the contemporaneously contributed cash should not be a disguised sale proceeds.\(^\text{108}\) To the extent that the liability that is satisfied is “anticipatory,” however, it seems appropriate, and consistent with congressional intent,\(^\text{109}\) to conclude that the partnership-level debt was merely transitory and that the partnership was used as a conduit through which to transfer proceeds from the contributing partner to the distributee.\(^\text{110}\) Consider the following examples.

**Example 9.** A, B, and C are partners in the ABC partnership, which is worth $10 million (the combined assets of the partnership have a net fair market value of $10 million). A owns a 40 percent, and B and C each owns a 30 percent, interest in the profits, losses, and capital of the partnership. One year ago, the partnership incurred a liability of $2 million to purchase partnership property (the “Property Liability”).

To fund a distribution to A, the partnership borrows an additional $2 million, recourse to all of the assets of the partnership, but nonrecourse to the partners, and distributes the $2 million in cash to A. Contemporaneously with the distribution to A, X contributes $2 million to the partnership in exchange for a 20 percent interest in the partnership. A’s interest is reduced to 20 percent, and X is admitted as a partner with a 20 percent interest. The partnership uses the $2 million contributed by X to satisfy the Property Liability.

In Example 9, A and X have not used the partnership as a conduit to transfer proceeds from X to A. Because the Property Liability was not incurred in anticipation of the

\(^\text{107}\) Treas. Reg. § 1.707-5(b)(1).

\(^\text{108}\) In determining whether a partnership liability should be considered “non-anticipatory,” the IRS and Treasury may wish to adopt the familiar definitions of “qualified liabilities” found in the Property Regulations. Treas. Reg. § 1.707-5(a)(6)(i)(A) – (D). Significantly, although all of the categories of qualified liabilities are in some sense non-anticipatory, non-anticipatory liabilities specifically constitute “qualified liabilities” under the Property Regulations. Treas. Reg. § 1.707-5(a)(6)(i)(B).

\(^\text{109}\) See the Senate Report, at 230.

\(^\text{110}\) See Waterman Steamship v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971) (corporate purchaser of a target corporation discharged the target corporation’s obligation to satisfy a pre-sale dividend distribution of a note distributed to target shareholders; the dividend distribution was not respected and purchaser’s discharge was treated as part of the purchase price).
contribution that was used to satisfy the liability, the liability should be respected as partnership-level debt.\footnote{The approach that we have suggested implicitly adopts a tracing regime similar to that of the Property Regulations with respect to debt-financed distributions. See Treas. Reg. § 1.707-5(b)(1).} We believe that the mere fact that X contributed cash to the partnership that was used to satisfy the Property Liability should not be viewed as having legal significance. Using contributed cash to satisfy a partnership liability should properly be viewed as using the cash in the partnership’s business. The partnership has simply determined that retiring a liability is a prudent use of funds. Taxpayers should not be required to change their business decisions merely to avoid overly-broad regulations. For these reasons, we recommend the Interest Regulations provide that transactions such as those described in Example 9 should not be recharacterized as a sale of A’s partnership interest.

**Example 10.** A, B, and C are partners in the ABC partnership, which is worth $10 million (the combined assets of the partnership have a fair market value of $10 million). A owns a 40 percent, and B and C each owns a 30 percent, interest in the profits, losses, and capital of the partnership.

To fund a distribution to A, the partnership intends to borrow $2 million, recourse to all of the assets of the partnership, but nonrecourse to the partners. Corporation X wishes to contribute $2 million to the partnership. In anticipation of X’s contribution, the partnership borrows $2 million, recourse to all of the assets of the partnership, but nonrecourse to the partners, and distributes the $2 million in cash to A. X contributes $2 million to the partnership in exchange for a 20 percent interest in the partnership. A’s interest is reduced to 20 percent, and X is admitted as a 20 percent interest partner. The partnership immediately uses the $2 million contributed by X to satisfy the liability that funded the distribution to A.

In Example 10, A and X have used the partnership as a conduit to transfer proceeds from X to A. Because the $2 million liability incurred by the partnership was incurred in anticipation of the contribution that was used to satisfy the liability and the liability is transitory, it should not be considered to have been partnership-level debt. Thus, we believe the transactions in Example 10 should be recharacterized as a sale of A’s partnership interest.

We note that some commentators have suggested the inclusion of an anti-abuse rule to address liabilities that are structured to effect a distribution under which the assets of a particular partner, directly or indirectly, provide the primary credit support for the liability, and that partner’s sharing of profits and losses is increased by an amount that corresponds to the reduction in the sharing by the distributee partner.\footnote{See the NYSBA Report, at 18-19.} We believe that abusive transactions would be treated as a disguised sale of a partnership interest under the double but for test and the other

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rules, such as those relating to partnership liabilities, we have suggested. Thus, a specific anti-abuse rule should be unnecessary.\textsuperscript{113}

E. The Interest Regulations Should Provide Overlap Rules

The characterization of a transaction as a contribution and distribution or as a sale of a partnership interest will determine whether the provisions of other Code sections (such as sections 704(c)(1)(B) and 737) apply. Rules are needed to determine the application of these provisions. Toward that end, we believe that the Interest Regulations should include a rule providing that a transaction that is treated as a sale of a partnership interest under the Interest Regulations is treated as a sale for all purposes of the Code.\textsuperscript{114}

There may also be transactions to which the Property Regulations and the Interest Regulations could both apply. For example, a new partner may contribute property to a partnership, and a partnership may distribute property to both the new partner (possibly implicating the Property Regulations) and another partner (possibly implicating the Interest Regulations). In such case, we believe that the Property Regulations should apply first, and, if the double but for test is satisfied, the Interest Regulations should subsequently apply to the portion of the transaction that is not treated as a disguised sale of property.

In addition, there may be transactions in which only a part of a contribution and distribution should be treated as a sale of a partnership interest. The Interest Regulations should provide an example similar to Example 11 below in which the transaction is recharacterized only in part as a disguised sale of a partnership interest, with the remainder of the contribution respected as such for federal income tax purposes.

\textbf{Example 11.} A, B, and C are partners in the ABC partnership, which is worth $10 million (the combined assets of the partnership have a fair market value of $10 million). A owns a 40 percent, and B and C each owns a 30 percent, interest in the profits, losses, and capital of the partnership.

A wants to have one half of his interest redeemed. Corporation X wants to acquire a 60 percent interest in the partnership. A and X, with the partnership’s cooperation, decide to structure part of the transaction as a contribution and distribution transaction. X contributes $12 million in cash to the partnership. Without a distribution to A, X would be admitted as a 54.5 percent partner. As part of a plan to increase X’s interest to 60 percent, $2 million is immediately distributed to A reducing half of A’s interest in the partnership (the partnership uses the remaining $10 million in its business). The contribution would not have

\textsuperscript{113} We also note that it is not at all clear that the examples found to be abusive by those commentators are in any meaningful sense abusive. Indeed, some of those examples appear to be transactions firmly rooted in the normal operating rules of subchapter K. As was noted above, Congress did not want the rules of section 707(a)(2)(B) to interfere with normal transactions that are rooted in the normal operating rules of subchapter K.

\textsuperscript{114} See Treas. Reg. § 1.707-3(a)(2) for a similar rule under the Property Regulations.
been made but for the distribution, and the distribution would not have been made but for the contribution.

Part of this transaction has the basic characteristics of a disguised sale of a 20 percent partnership interest. A starts as a 40 percent partner. X has contributed $12 million, $2 million of which is distributed to A. If the part of the transaction that should be treated as a sale of a partnership interest is analyzed first, X acquires a 20 percent interest, and A’s partnership interest is reduced to 20 percent. A receives a distribution equal to the fair market value of the partnership interest that has been “redeemed.” This transaction satisfies the double but for test. There has been (i) a contribution of money or other property to the partnership resulting in an increase in X’s partnership interest, (ii) a distribution of money or other property by the partnership to A resulting in a corresponding decrease in A’s partnership interest, and (iii) the contribution would not have been made but for the distribution, and the distribution would not have been made but for the contribution. Because the double but for test is satisfied, this part of the transaction should be treated as a sale of a partnership interest. With respect to the remaining $10 million contributed by X, X should be considered to have contributed $10 million to the partnership in X’s capacity as a partner.

Finally, in the case of a contribution of property by a partner to a newly formed partnership, only the Property Regulations should apply. The Interest Regulations should not be applicable because there was no partnership in existence in which an interest could have been sold. It would be helpful if the Interest Regulations made this point clear.

F. The Interest Regulations Should Include a De Minimis Rule

We believe that, as a matter of administrative convenience, the IRS and Treasury should include a de minimis rule in the Interest Regulations. Under this rule, the Interest Regulations would not apply to any transaction in which the amount of aggregate consideration that otherwise would be treated as sale proceeds does not exceed the lesser of (i) $250,000 (adjusted for inflation) or (ii) ten percent of the net fair market value of all of the interests in the partnership.

CONCLUSION

As we have discussed, disguised sales of partnership interests present little opportunity for tax abuse. This suggests that rules concerning this area should be drawn more narrowly than the Property Regulations, where the potential for tax abuse has been identified. Moreover, we believe the Interest Regulations should be more narrowly drawn because the Interest Regulations would result in a more substantial recharacterization than the Property Regulations.

115 See Treas. Reg. § 1.197-2(k), Example 17. In that example, one partner contributes property and another partner contributes cash to a newly-formed partnership. In exchange for his contribution, the first partner receives both a partnership interest and a distribution of the cash contributed by the second partner. The example concludes that the transaction is a sale of property by the first partner to the partnership.
In this regard, the Interest Regulations should incorporate the double but for test of causation that we have suggested and should provide for specific safe harbor provisions and other suggested exceptions and examples that have been discussed in this comment letter. Additionally, the Interest Regulations should provide that neither the allocation or reallocation of partnership liabilities under section 752 nor debt-financed distributions will be treated as part of a disguised sale of a partnership interest.

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April 2, 2004