Revenue Ruling 99-6, a Trap for the Unwary

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Rev. Rul. 99-6 Situation 1

- A and B are 50 percent partners.
- B buys A’s interest for cash.
- A is treated as if:
  - A sold its partnership interest to B.
- B is treated as if:
  - AB distributed all of its assets to A and B in liquidation of AB; and
  - B purchased from A the assets deemed to have been distributed to A.
**Rev. Rul. 99-6 Situation 2**

- C and D are equal partners.
- C and D sell their interests to E, a third-party purchaser, for cash.
- C and D are treated as if:
  - C and D sold their partnership interests to E.
- E is treated as if:
  - CD distributed all of its assets to C and D in liquidation of CD; and
  - E purchases the distributed assets from C and D.

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**McCauslen v. Commissioner, 45 T.C. 588 (1966)**

- McCauslen was a partner in a two-person partnership.
- McCauslen purchased the other partner’s interest.
- Less than 6 months later, McCauslen sold a portion of the partnership’s assets.
- Issue: Was McCauslen entitled under section 735(b) to include the partnership’s holding period for the assets sold?
- Holding: McCauslen’s holding period in the portion of the assets attributable to the acquired partnership interest does not include the partnership’s holding period in the assets.
Gain Acceleration:
Example 1 – Sections 741, 731 and 704(c)

- Partner A contributes $100 for a 50 percent interest in AB.
- Partner B contributes non-depreciable Asset B (basis $20 and FMV $100), to be used for investment purposes for the remaining 50 percent interest.
- AB partnership purchases non-depreciable Asset A for $100.
- The Partnership Agreement provides that Partner A is allocated 75 percent of the profits and losses of Asset A and Partner B is allocated 75 percent of the profits and losses of Asset B.

Treatment to Partner A: Section 741

- Assume that, two years later, neither asset has changed in value. AB sells Asset A for $100. Partner A then sells his 50 percent interest in AB to Partner B for $100.
- In such case, Partner A is treated as selling his interest and has neither gain nor loss on the sale ($100 received less $100 basis in partnership interest), Section 741.
Treatment to Partner B: Sections 731 and 704(c)

- Rev. Rul. 99-6 requires Partner B to treat the sale as if Partner A and Partner B first received a distribution of assets, but does not make clear whether Partner B is treated as receiving:
  - 50 percent of Asset A (cash) and 50 percent of Asset B.
  - 25 percent of Asset A (cash) and 75 percent of Asset B.
  - None of Asset A and all of Asset B.

Alternative 1:
Partner B Receives 50% of Asset A and 50% of Asset B

- Partner A is treated as receiving $50 and 50 percent of Asset B.
- Under section 704(c)(1)(B), Partner B recognizes gain as if AB had sold an undivided 50 percent interest in Asset B to Partner A, resulting in a $40 capital gain to Partner B, and increasing his basis in his partnership interest from $20 to $60.
- Partner B is then treated as receiving $50 cash and 50 percent of Asset B.
- Under Section 732, Partner B takes his undivided 50 percent interest in Asset B with a $10 basis ($60 basis less $50 cash distribution) and has no gain or loss.
Alternative 1:
Partner B Receives 50% of Asset A and 50% of Asset B (cont.)

- Partner B is then deemed to purchase Partner A’s $50 and 50 percent of Asset B for $100.
- Partner B’s basis in Asset B is increased to $60 ($10 plus $50 purchase price).
- Partner B has recognized $40 gain and has $40 of gain left to recognize.

Alternative 2:
Partner B Receives 25% of Asset A and 75% of Asset B

- Partner A is treated as receiving $75 and 25 percent of Asset B.
- Under section 704(c)(1)(B), Partner B recognizes gain as if AB had sold an undivided 25 percent interest in Asset B to Partner A. B recognizes a $20 capital gain on the deemed sale, increasing his basis in his partnership interest to $40.
- Partner B is then deemed to receive $25 cash and 75 percent of Asset B.
- Under Section 732, Partner B’s basis in his partnership interest is $15 under ($40 basis less $25 cash) and he has no gain or loss.
Alternative 2:
Partner B Receives 25% of Asset A and 75% of Asset B (cont.)

- Partner B is then deemed to purchase the other 25 percent of Asset B and $75 from Partner A for $100. This will give Partner B a $40 basis in Asset B ($15 plus $25).
- Under this scenario, Partner B has recognized $20 of gain ($20 less than Alternative 1) and has $60 of gain left to recognize.

Alternative 3:
Partner B Receives None of Asset A and All of Asset B

- Partner A is treated as receiving $100 cash. Thus, there is no section 704(c) impact on Partner B.
- Partner B is deemed to have received 100% of Asset B.
- Partner B takes a $20 basis in Asset B.
- Under this scenario, Partner B has recognized no gain ($40 less than Alternative 1 and $20 less than Alternative 2) and has $80 of gain left to recognize.
Additional Issues that Can Further Complicate Example 1

- Section 737: Although section 737 would not create additional gain to Partner B under the facts in Example 1, Rev. Rul. 99-6 could result in Section 737 gain under different facts.

Additional Issues that Can Further Complicate Example 1 (cont.)

- Section 751(b): For purposes of Section 751(b), is the partnership deemed to make distributions proportionate to the partners’ share of Section 751 assets?
- If not, will Partner B have to pick up the partnership’s share of any Section 751(b) income resulting from the deemed distribution to Partner A?
Additional Issues that Can Further Complicate Example 1 (cont.)

- Section 168(i)(7) provides a "step into the shoes" rule for depreciation purposes in the case of certain tax-free transfers of property, including pursuant to Section 731.
- However, Section 168(i)(7) would not apply with respect to the assets (or the undivided interest in assets) that Partner B is deemed to purchase from Partner A.
- Thus, it would be even more important to determine which assets are deemed distributed to each partner.

Disguised Sale of Property

- B contributed Property X to AB 12 months ago.
- Under Rev. Rul. 99-6, B receives a portion of all of the assets of AB in a deemed liquidation of AB.
- Could the deemed liquidating distribution to B be treated as part of a disguised sale of property under section 707(a)(2)(B)?
Allocation of Liabilities

- A and B are equal partners.
- A contributed Property Y with a fair market value of $40.
- B contributed Property X with a fair market value of $100 and a basis of $10. Property X was subject to a nonrecourse liability of $60.
- Under section 752, the $60 nonrecourse liability is allocated $55 to B and $5 to A.
- A sells its entire interest to B for $40.

Allocation of Liabilities (cont.)

- Under Rev. Rul. 99-6, A is treated as selling its partnership interest to B.
- A’s amount realized on the sale is $45 ($40 cash from B plus the amount of liabilities from which A is relieved under section 752(d) ($5)).
- From B’s perspective, the partnership is deemed to make a liquidating distribution of its assets (and presumably its liabilities) to A and B. B is then deemed to purchase A’s share of the assets and to assume A’s share of liabilities.
- How are the partnership’s liabilities allocated in the deemed liquidating distribution?
Allocation of Liabilities: Alternative #1 – Section 752(d)

- Section 752(d) governs the allocation of liabilities in the case of a sale or exchange of a partnership interest.
- Under the section 752(d) approach, B would be deemed to receive a liquidating distribution of the partnership’s assets with a fair market value of $95, subject to $55 of the nonrecourse liability.
- B would be deemed to receive the remaining assets of $45, subject to $5 of the nonrecourse liability.
- A would be treated as selling those assets, subject to the nonrecourse liability of $5, to B.

Allocation of Liabilities: Alternative #2 – PIP

- A and B are equal partners and receive 50% of all assets and liabilities. A and B each receive partnership assets with a fair market value of $70 subject to a nonrecourse liability of $30.
- A is treated as selling its share of the assets, subject to the nonrecourse liability of $30, to B.
- The assumption of $30 of the liability by A results in a shift of $25 of AB’s liabilities from B to A under section 752. This shift would result in a deemed distribution of $25 to B under section 752(b).
- B would recognize gain of $15 under section 731(a)(1) (the excess of the $25 distribution over B’s outside basis of $10).
Extinguishment of Liabilities

- A and B are equal partners.
- AB owns property with a fair market value of $100 and an adjusted tax basis of $40. The property is subject to a liability of $60 that is owed to B.
- A sells its entire interest in AB to B.
- AB becomes a disregarded entity. Thus, B will be treated as holding both the creditor and debtor interests in the $60 liability. The debt disappears for federal income tax purposes.
- There is a risk that the transaction could be treated as though the partnership satisfied the indebtedness to B with a portion of the property deemed distributed to B.
- If the partnership is treated as using appreciated property to satisfy the liability, the transaction could be treated as a sale of a portion of such property by the partnership and gain could be recognized.

Nonrecognition Transactions:
Mergers That Cause a Partnership to be Reclassified as a DRE

- T merges into A.
- In the merger, the shareholders of T exchange their T stock for A stock. P becomes a disregarded entity of A.
- Does Rev. Rul. 99-6 apply?
- If Rev. Rul. 99-6 applies, the liquidation of P (and the resulting deemed distribution of a portion of P’s assets to A and T) may result in gain recognition to A under section 731(a), the anti-mixing bowl rules of sections 704(c)(1)(B) and 737, section 751(b), or other provisions.
Section 1239:
Does Rev. Rul. 72-172 Apply?

- Under section 1239, any gain recognized on a sale of depreciable property to a related person is characterized as ordinary income.
- Husband and Wife owned partnership P. They sold their interests in P to their wholly-owned corporation. P owned land and a depreciable building.
- Rev. Rul. 72-172 held that section 1239 applied to the portion of the gain attributable to the building.
- Does section 1239 apply to the seller’s gain in a Rev. Rul. 99-6 transaction?

Section 1239:
Does Rev. Rul. 72-172 Apply? (cont.)

- Parent owns 100 percent of S1 and S2. Parent, S1, and S2 do not file a consolidated return.
- S1 and S2 are equal partners in partnership P. P holds depreciable property.
- S1 sells its interest in P to S2. S1 recognizes gain on the sale.
- Does section 1239 apply to S1’s gain?
Does Section 304 Apply?

- A and B, each a corporation, own 90 percent and 10 percent of the capital and profits of AB, respectively.
- AB owns 100 percent of the vote and value of Subsidiary, a corporation. AB also has a liability of $100.
- A and B contribute their interests in AB to Newco in a section 351 transaction.

Does Section 304 Apply? (cont.)

- Under Rev. Rul. 99-6, Newco is considered to have acquired both the stock of Subsidiary and the $100 liability from A and B.
- Because Newco may be considered to have acquired the stock of Subsidiary in return for property (the $100 liability assumption) from a controlling person, section 304 may apply.
Section 197 Intangibles:
Anti-Churning Rules

- A and B are equal partners. B buys A’s interest in AB for cash.
- If the partnership has section 197(f)(9) intangibles, including goodwill, B will not be able to amortize B’s basis in those intangibles.
- Anti-churning rules apply if the transferee of an intangible acquired it from a person that was related to the transferee (by 20 percent) immediately before the first transaction in a series of related transactions or immediately after the last transaction. Treas. Reg. § 1.197-2(h)(6).
- Because B is related to the partnership (the holder or user of the intangible) immediately before the first transaction (the partnership liquidation), the anti-churning rules apply.

Section 197 Intangibles:
Alternative Transaction

- A sells its entire interest in AB to Subsidiary, a corporation wholly owned by B.
- AB makes a section 754 election and adjusts the basis of its property, including goodwill, with respect to Subsidiary under section 743(b).
- Anti-churning rules do not apply because Subsidiary acquired the interest in AB from A, a person not related to Subsidiary.
Planning Around Revenue Rule 99-6

- The consequences of Revenue Rule 99-6 to Partner B can be avoided by adding minority Partner C before Partner A leaves the partnership.
- Unintended consequences to Partner B may also be avoided through a redeeming liquidation of Partner B. Query whether it is possible to avoid the consequences of Revenue Ruling 99-6 by selecting which assets are deemed distributed to each partner without an actual liquidation?
- Since the consequences of the Revenue Ruling can often be avoided, the Revenue Ruling becomes a trap for the unwary.
- However, in addition to being a trap for the unwary, there may be situations in which Partner B is prevented from planning around Revenue Ruling 99-6 (e.g., if Partner B would like to bring in Partner C before Partner A leaves, but there are lender restrictions preventing such action from occurring).