Disguised Partner Sales Memorandum

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I. Introduction.

A. In General. The partnership tax law was developed to allow for the free flow of property to a partnership and distribution from a partnership without incurring any income tax or recognition of gain.

B. Unintended Use. A partner could avoid the recognition of gain by contributing appreciated property to the partnership followed by a cash distribution or distribution of different property to that partner. In addition, the partnership could distribute that appreciated property to another partner.

(1) Example No. 1. In Otey vs. Commissioner. 634 F. 2nd 1046 (6th Cir. 1980) the taxpayer partner recognized no gain when he contributed appreciated property to a partnership and in turn the partnership distributed cash to that partner equal to the property's value.

(2) Example No. 2. No gain was recognized when a partnership was formed by one partner contributing land and the other partner contributing nonmarketable securities and later on the partnership was liquidated with each partner receiving a distribution of the other partner's property.

(3) Legislation. In 1984 Congress enacted Internal Revenue Code (IRC) Section 707(a)(2)(B) which overturned the result in Otey and directed Treasury to write regulations to determine when a contribution and related distribution would be characterized as a sale with gain recognition. Later on Congress enacted IRC Section 704(c)(1)(B) and 737 as a backup to IRC Section 707(a)(2)(B) to identify in what situations Example No. 2 could be subject to gain recognition as a sale.

II. IRC Section 707(a)(2)(B) and its Treasury Regulations

A. Simultaneous Reciprocal Transfers. If the partnership would not have transferred cash or property to a partner but for the transfer of property by the partner to the partnership, the transaction will be treated as a sale. The date of the sale is the date of the contribution of the property.

B. Non-Simultaneous Reciprocal Transfers. If the subsequent transfer of property is not dependant on the entrepreneurial risk of the partnership's operations, the transaction will be treated as a sale. However, if the contributing partner's capital is at risk for a sufficient amount of time, the transaction will not be treated as a sale.

(1) If the contribution and distribution occur within two years of one another, the transfers are presumed to constitute a sale. However, the regulations provide exceptions for distributions out of operating cash flow, reasonable guaranteed payments and preferred returns.

(2) If the contribution and distribution occur more than two years from one another,

the transfers are presumed not to constitute a sale.

(3) These presumptions can be rebutted if the facts and circumstances clearly establish the contrary. The Treasury Regulations in Section 1.707-3(b)(2) list ten of the most important facts and circumstances that tend to show the existence of a sale.

C. Liabilities. When property subject to a liability is transferred to a partnership, the contributing partner is deemed to have received cash to the extent of the reduction of the partner's obligation to pay the liability. This deemed distribution is a nonrecognition event under IRC 752 unless it is a disguised sale where the liability was incurred in anticipation of the transfer of the property to the partnership. The Treasury Regulations distinguish between qualified liabilities and nonqualified liabilities.

(1) Qualified Liabilities. Qualified liabilities are not subject to gain recognition. When the liability was incurred and the uses of the proceeds are the important factors.

a. If the liability was incurred more than two years prior to the transfer of the property to the partnership and the liability remained on the property, it is a qualified liability.

b. If the liability was incurred within two years prior to the transfer of the property to the partnership and the liability was for capital expenditures, it is a qualified liability. Or, if the liability was incurred in the ordinary course of business and substantially all the assets are transferred to the partnership, it is a qualified liability.

(2) Non-Qualified Liabilities. If a liability is not qualified, it is considered nonqualified and subject to gain recognition. For recourse liabilities, the gain is the excess of the liability over the contributing partner's share of the liability after it is transferred to the partnership. For nonrecourse liabilities, the excess amount is determined by the partner's profit sharing ratio. In addition, if the partnership incurs a liability and within ninety days distributes proceeds to the contributing partner there is nonqualified liability if the amount distributed exceeds the contributing partner's share of the liability.

III. IRC Section 704(c)(1)(B) and its Treasury Regulations

If a partner contributes appreciated property to a partnership and that property is distributed to another partner within seven years of the original contribution, the contributing partner has gain recognition as if the property had been sold for its fair market value on the date of the distribution.

IV. IRC Section 737 and its Treasury Regulations

If a partner contributes appreciated property to a partnership and the contributing partner receives a distribution of property other than the contributed property within seven years of the contribution, there is recognition of gain. The amount of the gain is the lesser of

A. The distributed property's value less the contributing partner's outside basis, or

B. Net recognized gain by the contributing partner as if all the property contributed by the contributing partner within seven years of the distribution and still held by the partnership were distributed to another partner.

V. Disguised Sales of Partnership Interests

If one partner purchases another partner's interest in a partnership there is gain recognition. However, if one partner acquires an interest in the partnership and the partnership distributes property to another partner in liquidation of distribution partner's interest, this may be a disguised purchase and sale of a partnership interest. Treasury issued proposed regulations in 2004 but they were severely criticized and have not been finalized. Basically the proposed regulations followed the disguised sale of property rules discussed in Parts I, II, III, and IV.

VI. Rule of Thumb Conclusions

A. Take distribution form operating cash flow, reasonable guaranteed payments and preferred returns.

B. Only take other distributions that are more than two years from your contribution.

C. Only transfer encumbered property where the liability was incurred more than two years from the date of the contribution or if the liability was incurred within two years, the liability was used to acquire or improve the property or used for capital expenditures.

D. If you contribute appreciated property, only distribute that property to another partner if the partnership has held that property more than seven years.

E. If you contribute appreciated property, and only take a distribution of other property if more than seven years have elapsed from the time you contributed the property.