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Uncovering Disguised Sales: An Analysis of the Partnership Disguised Sale Rules

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I. Introduction

A partner contributes property to a partnership and then receives a distribution of cash from the partnership. How should this transaction be treated for tax purposes? Should it be viewed as (1) a tax-free contribution of property by a partner to a partnership under section 721 of the Internal Revenue Code (the "Code"),[1] followed by a distribution of property from the partnership to the partner under section 731 that would be tax-free to the extent of the partner's basis in its partnership interest; or as (2) a taxable sale of property from the partner to the partnership? How would it affect the characterization of the transaction if the partnership assumes debt of the partner in connection with the transaction? What factors would be relevant to making these determinations?

Taxpayers have long tried to take advantage of favorable rules under subchapter K of the Code relating to contributions to, and distributions from, partnerships -- even as they carried out transactions in substance similar (or identical) to a taxable sale. When enacted in 1954, section 707(a) attempted to address this issue by providing that "[i]f 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." Section 1.731-1(c)(3) of the Treasury Regulations (the "Regulations"), promulgated in 1956, provides that a distribution to a partner does not qualify under section 731 if there is a contribution of property to a partnership and "within a short period before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership."[2]

Notwithstanding these provisions, several cases decided in the late 1970's and early 1980's failed to treat transactions between partners and partnerships as disguised sales in situations that Congress considered to be "indistinguishable from a sale of property."[3] Accordingly, Congress added section 707(a)(2)(B) to the Code in 1984. That section provides generally that related transfers of money or other property between a partner and a partnership will be treated as a sale of property if they are "properly characterized as a sale or exchange of property." In 1992, the Treasury promulgated Regulations (referred to herein as the "Disguised Sale Regulations") that govern the circumstances under which transfers between a partner and partnership will be characterized as a sale of property under section 707(a)(2)(B) (that is, a "disguised sale of property").[4] These Regulations, although often complex, go a long way toward providing taxpayers with certainty as to which transactions will be treated as a disguised sale of property.

Unfortunately, though, these Regulations are ambiguous in certain fundamental aspects, and additional guidance from the IRS or Treasury continues to be needed.

Many of the hot-button disguised sale issues in today's transactions involve the application of some of the finer points of the Disguised Sale Regulations. This article first provides an overview of the overall approach taken by the Disguised Sale Regulations, and then takes a deeper look at provisions related to assumptions of liabilities, debt-financed distributions, and reimbursements of capital expenditures. Finally, it explores the overall scope of the Disguised Sale Regulations.

II. Overview of the Disguised Sale Rules

A contribution of property by a partner to a partnership is generally tax-free under section 721, and a distribution of property from a partnership to a partner is generally tax-free to the extent of the partner's basis in its partnership interest under section 731. However, section 707(a)(2)(B) provides that, under certain circumstances, a partner's contribution of money or other property to a partnership and a related distribution of money or other property from the partnership to the partner will be treated as a sale of property between the partner and the partnership (i.e., a disguised sale of property). Specifically, these related transfers will be treated as a disguised sale of property if, when viewed together, they are "properly characterized as a sale or exchange of property."[5]

Regulation section 1.707-3 includes the basic rules relating to disguised sales of property by a partner to a partnership.[6] Regulation section 1.707-3(a)(1) provides that, "[e]xcept as otherwise provided in this section, if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in paragraph (b)(1) of this section, the transfers are treated as a sale of property, in whole or in part, to the partnership." Regulation section 1.707-3(b)(1) provides:

> 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—
>
> > (i) The transfer of money or other consideration would not have been made but for the transfer of property (referred to herein as the "but-for condition"); 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 (referred to herein as the "entrepreneurial risk condition").

Regulation section 1.707-3(b)(2) provides that "[t]he determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, under paragraph (b)(1) of this section is made based on all the facts and circumstances in each case" and that "[t]he weight to be given each of the facts and circumstances will depend on the particular case."

Regulation section 1.707-3(b)(2) then provides that "[a]mong the facts and circumstances that may tend to prove the existence" of a disguised sale of property are the following ten factors:

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);

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.

A. Analysis of the Overall Approach of the Disguised Sale Regulations

How do paragraphs (b)(1) and (b)(2) of Regulation section 1.707-3 interact with each other? It would appear that the facts and circumstances test of paragraph (b)(2) is intended to provide the facts and circumstances that are relevant for purposes of applying the two conditions set forth in paragraph (b)(1) for having a disguised sale, since paragraph (b)(2) introduces the facts and circumstances test

by stating that the determination of whether the transfers constitute a disguised sale "under paragraph (b)(1)" depends on all of the facts and circumstances. If so, then it would seem to follow that transfers constitute a disguised sale whenever, under all the facts and circumstances, both of the conditions of paragraph (b)(1) are satisfied. This is consistent with the provision in paragraph (a)(1) that, except as otherwise provided, transfers described in paragraph (b)(1) are treated as a disguised sale.

However, under Code section 707(a)(2)(B), there cannot be a disguised sale unless the two transfers "are properly characterized as a sale or exchange of property." If the Disguised Sale Regulations are understood to provide that there automatically is a disguised sale *whenever* both the "but-for condition" and the "entrepreneurial risk" condition are satisfied, it would seem like the Regulations might be partially negating the Code's precondition to having a disguised sale. It appears that there could be cases where these two conditions are satisfied, but the transfers nonetheless would not be "properly characterized as a sale or exchange of property."[7]

It may be possible to read Regulation section 1.707-3 to provide that (1) there definitely is not a disguised sale if either the "but-for condition" or the "entrepreneurial risk" condition is not satisfied and (2) if both of these conditions are satisfied, then the determination of whether or not there is a disguised sale depends on the facts and circumstances test of paragraph (b)(2). Perhaps support for this reading of the Disguised Sale Regulations could be found from the fact that paragraph (b)(1) provides that the transfers constitute a disguised sale "*only*" if these two conditions are satisfied. Thus, paragraph (b)(1) provides that that there *cannot* be a disguised sale if either of the conditions is not satisfied, but was written in a manner such that it implies that there is not necessarily a disguised sale if both of the conditions are satisfied. It would seem that, in light of the "properly characterized as a sale or exchange of property" language in Code section 707(a)(2)(B), this wording in Regulation section 1.707-3(b)(1) could leave open the possibility of there *not* being a disguised sale notwithstanding both of the conditions being satisfied if, under *all* of the facts and circumstances, the transfers would not be properly characterized as a sale under paragraph (b)(2).[8] If this alternative reading is viable, then it would create something of a common sense overlay to the Regulations.[9]

B. Presumptions and Safe Harbors

In contrast to the open-ended "facts and circumstances" test, the Disguised Sale Regulations include a presumption that, if the two transfers occur within a two-year period of each other, the transfers constitute a sale "unless the facts and circumstances clearly establish that the transfers do not constitute a sale."[10] As a means of implementing this negative presumption, a special disclosure is required if the two transfers occur within a two-year period, but the transaction is not reported by the taxpayer as a disguised sale.[11] On the other hand, if the two transfers are more than two years apart, they are presumed not to constitute a disguised sale "unless the facts and circumstances clearly establish that the transfers constitute a sale."[12] Given that the 10-part test of the Disguised Sale Regulations is generally unhelpful for purposes of determining with any degree of certainty whether a transaction constitutes a disguised sale of property, the presumptions have, as a practical matter, become critical for determining whether or not a transaction will be treated as a disguised sale of property.[13]

There are certain exceptions under which a transaction that generally would be treated as a disguised sale of property instead will be excluded (in whole or in part) from disguised sale treatment. These exceptions apply, under certain circumstances, where the distribution to the partner is a guaranteed

payment,[14] preferred return,[15] operating cash flow distribution,[16] reimbursement of certain capital expenditures,[17] or a debt-financed distribution.[18]

C. Mechanics of a Disguised Sale of Property

Transfers between a partnership and a partner that constitute a disguised sale of property are treated as a sale for all purposes of the Code.[19] The sale is considered to take place on the date that, under general principles of Federal tax law, the partnership is considered to become the owner of the property.[20] If the transfer of money or other consideration from the partnership to the partner occurs after that date, the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer the money or other consideration to the partner.[21] This transaction, in appropriate circumstances, could qualify as an installment sale under section 453.

Where a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner pursuant to what is considered to be a disguised sale of property, the portion of the property that the partner is considered to sell to the partnership depends on the fair market value of the property and on the amount of money or other consideration received by the partner. If the partner is considered to sell only a portion of the property to the partnership, the partner is considered as contributing the remaining portion under section 721. The following example illustrates the mechanics of a simple disguised sale of property where only a portion of the property is considered to be sold.

Example 1:[22]

Facts: X transfers an unencumbered property to a partnership and then, immediately thereafter, the partnership transfers $3,000,000 of cash to X. The property has a value of $4,000,000 and a basis of $1,200,000.

Analysis: X is considered (1) to have sold a portion of the property worth $3,000,000 -- that is, 75% (i.e., $3,000,000 / $4,000,000) of the property -- to the partnership in exchange for $3,000,000 and (2) to have contributed a portion of the property worth $1,000,000 to the partnership in exchange for partnership interests under section 721. As part of the sale, X recovers a pro rata portion of his $1,200,000 basis, or $900,000, in accordance with the 75% of the property that is considered to be sold. X accordingly recognizes $2,100,000 of gain on the sale (i.e., the excess of $3,000,000 amount realized over $900,000 of basis recovery). X recognizes no gain on portion of the property that is considered to be contributed under section 721. The partnership receives (1) a $3,000,000 fair market value basis in the 75% portion of the property that is considered to be sold and (2) a $300,000 carryover basis (with a "tacked" holding period) in the 25% portion of the property that is considered to be contributed (i.e., 25% of X's $1,200,000 basis).

III. Assumption of Liabilities

Consider a case where a partner takes out a $1 million nonrecourse loan secured by a mortgage on a property for personal uses and then, the very next day, contributes the property to a partnership subject to the debt. Alternatively, suppose that the partner had taken out the loan a year before contributing the property and used the debt proceeds to renovate the property. It seems clear that the first case should be treated as a disguised sale of property, since the transaction is virtually identical to the

partner contributing the unencumbered property to the partnership and then having the partnership distribute $1 million of cash to the partner. It also seems clear that the second case should not be treated as a disguised sale of property, since all the cash was invested in property that was subsequently contributed to the partnership. Intermediate cases, however, pose a more complicated question. For example, what should the tax treatment be in a case where the partner takes out the loan for personal uses three years before contributing the property to the partnership and at a time when he had only considered the possibility of contributing the property, but had no concrete plans or agreement for doing so?

The approach taken by the Treasury in the Disguised Sale Regulations is to make a distinction between the assumption of a "qualified" liability and the assumption of a liability that is not "qualified." The term "qualified liability" is defined to include a liability assumed or taken subject to by a partnership in connection with a transfer of property to a partnership by a partner if any one of the following four criteria is met:[23]

- The liability (1) was incurred by the partner more than two years prior to the earlier of (i) the date the partner agrees in writing to transfer the property or (ii) the date the partner transfers the property to the partnership and (2) has encumbered the transferred property throughout the two-year period.[24]

- The liability was incurred by the partner within the two-year period referred to above, but (1) was not incurred in anticipation of the transfer of the property to a partnership and (2) has encumbered the transferred property since it was incurred.[25]

- The liability is allocable under the "interest-tracing" rules of Regulation section 1.163-8T to capital expenditures with respect to the property.[26]

- The liability was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held, but only if all the assets related to that trade or business (other than assets that are not material to a continuation of the trade or business) are transferred.[27]

A. Assumption Solely of Nonqualified Liabilities

Regulation section 1.707-5(a)(1) provides that, if a partnership assumes a liability of a partner or takes property subject to a liability of a partner and the liability is not a "qualified liability," the partnership is treated as transferring consideration to the partner in an amount equal to the excess of (i) the amount of the liability that was assumed or taken subject to by the partnership over (ii) the partner's "share" of the liability immediately after the partnership assumes or takes subject to the liability.[28] Under Regulation section 1.707-5(a)(2), a partner's "share" of a liability for purposes of the Disguised Sale Regulations depends on whether the liability is a recourse liability or a nonrecourse liability. For a recourse liability, a partner's share of the liability is equal to the partner's share under section 752 and the Regulations thereunder (i.e., generally the extent to which the partner bears the economic risk of loss).[29] For a nonrecourse liability, a partner's share of the liability is determined by applying the percentage used to determine the partner's share of "excess nonrecourse liabilities" of the partnership under Regulation section 1.752-3(a)(3) (i.e., generally the partner's share of partnership profits).[30] If a partner contributes property to a partnership and the partnership's assumption of a liability of the partner is treated as a trans-

fer of consideration under Regulation section 1.707-5, a determination of whether the transaction is treated as a disguised sale of property is then made under the general rules of Regulation section 1.707-3.

The following example illustrates the tax consequences where a partner transfers property to a partnership subject to a nonqualified liability.

Example 2:[31]

Facts: X and Y form a new partnership. X transfers $500,000 of cash to the partnership, and Y transfers to the partnership a property with a gross value of $1,000,000 that is subject to a $500,000 nonrecourse liability that is not a qualified liability. The property has an adjusted basis of $400,000. Each of X and Y has a 50% share of the partnership's excess nonrecourse liabilities.

Analysis: Since Y has a 50% share of the partnership's excess nonrecourse liabilities, Y has a $250,000 share of the liability after the assumption for purposes of the disguised sale rules (i.e., 50% of $500,000). Therefore, Y is considered to have been relieved of $250,000 of the liability (i.e., the excess of the $500,000 amount of the liability over Y's $250,000 share of the liability after the assumption). The partnership would be considered to transfer $250,000 of cash to Y for purposes of Regulation section 1.707-3. Assuming that Y is unable to rebut the presumption of the transfers constituting a disguised sale, the partnership would be considered to transfer $250,000 of cash to Y in exchange for a portion of the property worth $250,000 pursuant to a disguised sale of this portion of the property. Y allocates $100,000 of his basis to the sold portion of the property -- that is, 25% of his $400,000 basis (i.e., the percentage obtained by dividing the $250,000 amount realized in the sale by the $1,000,000 gross value of the property). Thus, Y would have $150,000 of gain on this sale (i.e., the excess of the $250,000 amount realized over $100,000 of basis recovery). The remaining portion of the property would be considered to be contributed by Y to the partnership under section 721.[32]

B. Contribution of Money Together with the Assumption of a Nonqualified Liability

Regulation section 1.707-5(d) provides that if, pursuant to a plan, a partner transfers money to a partnership and the partnership assumes or takes subject to one or more nonqualified liabilities of the partner, the amount of those liabilities that the partnership is treated as assuming or taking subject to is reduced (but not below zero) by the money transferred. The following example illustrates this provision.

Example 3:

Facts: Suppose that the facts are the same as in Example 2 (above), except that X and Y each transfers an additional $250,000 of cash to the partnership.

Analysis: Under Regulation section 1.707-5(d), the partnership would be considered to assume only $250,000 of liabilities from Y (i.e., the $500,000 nonrecourse liability reduced by the $250,000 of cash contributed by Y). Therefore, the partnership would be considered to transfer $125,000 to Y as part of a disguised sale (i.e., the excess of the $250,000 amount of the liability over Y's $125,000 50% share of the liability after its assumption).

Note that the contribution of $250,000 by Y, who would have been considered to receive a transfer of $250,000 from the partnership as part of a disguised sale in the absence of this cash contribution, reduces Y's disguised sale proceeds only to $125,000 (but not to $0). This is the result because the Regulations do not reduce the $250,000 that Y would be considered to receive in a disguised sale in the absence of Y's contribution (i.e., the reduction in Y's share of the liability from $500,000 to $250,000) by the $250,000 contribution by Y. Instead, as noted above, the $250,000 contribution by Y reduces the amount of the liability that is considered to be assumed from Y by the partnership (i.e., from $500,000 to $250,000), which has the effect of Y being considered to be relieved of 50% of a $250,000 liability instead of 50% of a $500,000 liability.

Does this approach of the Regulations make sense? Consider a situation where a partner contributes property and cash to a partnership and receives a distribution of cash from the partnership. Although the Regulations do not explicitly deal with such a scenario, it seems that the result should be that the partner's amount realized from receipt of the cash distribution should be reduced dollar-for-dollar by the amount of cash contributed by the partner. In Example 2, when Y had a $250,000 reduction in his share of the nonqualified liability, the Regulations treat it as though Y received a $250,000 cash distribution from the partnership. It would seem reasonable to suggest that this amount realized should be reduced dollar-for-dollar for the $250,000 of cash contributed by Y in Example 3 -- just as the result apparently would be if the partnership had actually transferred $250,000 of cash to Y instead of assuming the liability and Y had transferred $250,000 of cash to the partnership as part of the same transaction. However, this clearly is not the approach of the Disguised Sale Regulations.

C. Assumption of Qualified Liabilities

If a transfer of property by a partner to a partnership would not be treated as part of a sale in the absence of an assumption of a qualified liability, then the partnership's assumption of or taking subject to a qualified liability of the partner in connection with the transfer of property is not treated as part of a disguised sale.[33] On the other hand, if a transfer of property by a partner to a partnership would be treated as part of a disguised sale without taking into account any assumption of a qualified liability, then a portion of the partnership's assumption of or taking subject to a qualified liability is treated as a transfer of consideration by the partnership to the partner for purposes of the Disguised Sale Regulations.[34] In such a transaction, the partnership's assumption of the qualified liability is treated as a transfer of consideration made pursuant to a sale of property only to the extent of the *lesser* of the following:

(1) The amount of consideration that the partnership would be treated as transferring to the partner under Regulation section 1.707-5(a)(1) if the liability were not a qualified liability; or

(2) The amount obtained by multiplying the amount of the qualified liability by the partner's "net equity percentage" with respect to the contributed property.[35]

In general terms, net equity percentage is the amount of disguised sale proceeds that are considered to be transferred from the partnership to the partner divided by the net value of the contributed property. More specifically, the Regulations provide that a partner's "net equity percentage" with respect to an item of property equals the percentage determined by dividing:

(1) the aggregate transfers of money or other consideration to the partner by the partnership (including transfers considered to be made as a result of the assumption of a nonqualified liability, but *not* including transfers considered to be made as a result of the assumption of a qualified liability); by

(2) the excess of the fair market value of the property at the time it is transferred to the partnership over any qualified liability encumbering the property (i.e., a measure of the net value of the property that is not reduced by nonqualified liabilities).[36]

The following example illustrates the tax consequences of a partnership assuming both a qualified liability and a nonqualified liability from a partner in connection with a transfer of property by the partner to the partnership.

Example 4:

Facts: X transfers to a partnership a property with a gross value of $1,500,000, subject to (1) a $200,000 nonqualified liability and (2) a $500,000 qualified liability. The partnership transfers no consideration to X other than the assumption of these liabilities. After the transaction, X has a 50% share of excess nonrecourse liabilities of the partnership. X has a basis of $300,000 in the property.

Analysis: Had the partnership taken the property subject to only the qualified liability, there would have been no disguised sale at all. However, since the property is taken subject to both a qualified liability and a nonqualified liability, the partnership will be considered to transfer consideration to X as a result of the assumption of not only the nonqualified liability, but also the qualified liability.

As a result of the assumption of the nonqualified liability, X will be considered to receive $100,000 from the partnership (i.e., the excess of the $200,000 amount of the liability over X's $100,000 share of the liability after the assumption) as part of a disguised sale. As a result of the assumption of the qualified liability, X will be considered to receive an amount equal to the lesser of the following:

- $250,000 -- the amount that X would be considered to receive if the qualified liability were a nonqualified liability -- i.e., the excess of the $500,000 amount of the liability over X's $250,000 share of the liability after the assumption; and

- $50,000 -- i.e., the $500,000 amount of the qualified liability multiplied by the net equity percentage of 10%. (The 10% figure for the net equity percentage is obtained by dividing (1) the $100,000 of consideration that X would be considered to receive in the absence of the assumption of the qualified liability by (2) $1,000,000 -- i.e., the $1,500,000 gross value of the property less the $500,000 amount of the qualified liability encumbering the property).

Therefore, X has an amount realized of $150,000 on the disguised sale (i.e., the sum of $100,000 from the assumption of the nonqualified liability and $50,000 from the assumption of the qualified liability). X allocates a pro rata portion of his $300,000 basis to the part of the property that is considered to be sold, or $30,000, in accordance with the 10% of the property that is considered to be sold (i.e., $150,000 amount realized divided by the $1,500,000 gross value of the property). X accordingly recognizes

$120,000 of gain on the sale (i.e., the excess of $150,000 of amount realized over $30,000 of basis recovery).[37]

Thus, where a partner contributes property to a partnership subject to both a nonqualified liability and a qualified liability, the Regulations first consider a portion of the property to be sold for cash as a result of the assumption of the nonqualified liability. Then, the Regulations seem to attempt to include the portion of the qualified liability in amount realized similar to what the partner's amount realized would have been had the partner sold the same portion of the property to the partnership for cash in a "non-disguised" sale.[38]

D. Subsequent Reduction in a Partner's Share of a Liability

Regulation section 1.707-5(a)(3) provides that a partner's share of a liability immediately after the partnership assumes or takes subject to the liability is determined by taking into account a subsequent reduction in the partner's share if:

> (i) At the time that the partnership assumes or takes subject to the liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced; and
>
> (ii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a disguised sale.

Example 3 of Regulation section 1.707-5(f) considers a case where a partner ("C") contributes a property with a $10,000,000 gross value to a partnership subject to an $8,000,000 nonqualified liability. The property is a fully leased office building, the rental income of which is sufficient to meet debt service. Upon the partnership's assumption of the liability, the liability is a recourse liability of the partnership, and C's share of the liability is $7,000,000. The example states that it is anticipated that C's share of the liability will automatically decrease to zero three years after the partnership's assumption of the liability because of a shift in the allocation of partnership losses pursuant to the terms of the partnership agreement. The Regulations provide that, if (1) this subsequent reduction in C's share of the liability was anticipated at the time of C's transfer to the partnership and (2) the reduction was part of a plan that has as one of its principal purposes minimizing the extent that there will be considered to be a disguised sale, then C's share of the liability immediately after the assumption would be the reduced share (i.e., $0). C would be considered to receive $8,000,000 from the partnership as a result of the partnership's assumption of the $8,000,000 nonqualified liability.

Suppose that, instead of the future reduction in C's share of the liability, it is anticipated at the time of the assumption of the liability that the partnership would use operating cash flow to repay the liability 18 months after the assumption. Although this scenario is similar to the example in the Regulations in that it is anticipated that C's share of the liability would decrease to zero, this scenario has a much less abusive feel than the example in the Regulations. Perhaps C might contend that the reference of the Regulations to a reduction in "share" refers to *percentage* share and not to *absolute* share of the liability -- and that C would not have a reduction in "share" since there would be no decrease in C's share of the liability relative to the other partners. In addition, under the right circumstances, C may be able to contend

that, even if it is anticipated that there would be a reduction in C's share of the liability, such a reduction would not be part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a disguised sale.

E. Liability Assumption in Connection with a Partnership Merger

The following example illustrates a potential trap for unsuspecting taxpayers with respect to the interaction between the rules governing disguised sales involving assumptions of liabilities and the rules governing partnership mergers.

Example 5:

Facts: Partnerships A and B merge in an "assets-over" partnership merger. The partners of A prior to the merger will own 50.01% of the capital and profits interests in the resulting partnership, and the partners of B prior to the merger will own 49.99% of the capital and profits interests in the resulting partnership. Both A and B have nonqualified liabilities. Each partnership owns a property that has built-in gain and neither partnership is insolvent.

Analysis: A is the continuing partnership (and B is the terminating partnership) by virtue of the fact that (1) the partners of A own greater than 50% of the capital and profits interests in the resulting partnership and (B) the partners of B own less than 50% of the capital and profits interests in the resulting partnership.[39] In the assets-over partnership merger, B is considered to contribute all of its assets to A in exchange for interests in A (and A is considered to assume the liabilities of B), and then B is considered to make a liquidating distribution of its interests in A to its partners.[40] Based on this characterization of the transaction, it appears that B would have gain from a disguised sale since (1) B contributed appreciated property to A and (2) A assumed nonqualified liabilities of B. Gain from such a disguised sale would be allocated to the persons who are partners of B prior to the partnership merger. In contrast, A would not be considered to transfer any property or have any liabilities assumed by another partnership, so the persons who are partners of A prior to the partnership merger would not be allocated any gain from a disguised sale.

It may seem surprising that some of the partners (i.e., the pre-merger partners of B) have disguised sale gain while other of the partners (i.e., the pre-merger partners of A) do not have any disguised sale gain -- when this distinction is caused solely by the fact that the original partners of A own 0.02% more of the capital and profits interests of the resulting partnership than do the original partners of B. This seems, however, to be the outcome that results from applying the partnership merger Regulations and the Disguised Sale Regulations.[41] Yet, the fact remains that A's assumption of nonqualified liabilities of B would mean only that A is considered to transfer consideration to B for purposes of the disguised sale rules of Regulation section 1.707-3. One might still argue that, under Regulation section 1.707-3, there is no disguised sale based on all the facts and circumstances.

IV. Debt-Financed Distributions

Suppose that a partner and a partnership want to structure a tax-free transaction where the partner transfers appreciated property to a partnership and then, immediately thereafter and pursuant to a binding agreement, the partnership transfers cash to the partner. Although this sounds like a classic dis-

guised sale scenario, it may be possible for this transaction to be tax-free under the "debt-financed distribution" exception found in Regulation section 1.707-5(b).[42]

The debt-financed distribution provision applies where a partnership incurs a liability and either all or a portion of the proceeds of that liability is allocable under the "interest tracing" rules of Regulation section 1.163-8T to a transfer of money or other consideration to a partner made within 90 days of incurring the liability.[43] More specifically, the transfer of money or other consideration by the partnership to the partner is taken into account for purposes of the disguised sale rules only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds the partner's "allocable share of the partnership liability." Regulation section 1.707-5(b)(2)(i) provides that a partner's "allocable share of the partnership liability" equals the amount obtained by multiplying (1) the partner's share of the liability under Regulation section 1.707-5(a)(2) by (2) the fraction determined by dividing (i) the portion of the liability that is allocable under Regulation section 1.163-8T to the money or other property transferred to the partner by (ii) the total amount of the liability.[44]

Consider the following example with respect to a partnership that wants to make a debt-financed distribution.

Example 6:

Facts: X contributes to a partnership an unencumbered property with a $5,000,000 value and a $1,000,000 basis. Immediately thereafter, the partnership incurs $1,000,000 of nonrecourse debt secured by a mortgage on a previously unencumbered property owned by the partnership and distributes the $1,000,000 to X. X has a 25% share of the partnership's "excess nonrecourse liabilities."

Since the new $1,000,000 partnership debt is a nonrecourse liability, X has a $250,000 "share" of the liability under Regulation section 1.707-5(a)(2), in accordance with X's 25% share of the partnership's excess nonrecourse liabilities under Regulation section 1.752-3(a)(3). Since the full amount of the liability is allocable under Regulation section 1.163-8T to money transferred to the partner within 90 days of incurring the liability, X's "allocable share" of the partnership liability under Regulation section 1.707-5(b)(2)(ii) would be $250,000.[45] This means that only $250,000 of the cash transferred to X would qualify as a debt-financed distribution, and X would receive the other $750,000 as part of a disguised sale.

Suppose that X wants to structure the transaction so that he can receive the entire $1,000,000 as a tax-free debt-financed distribution. This could be accomplished by having X guarantee the new partnership liability. X guaranteeing this debt would cause the debt to be treated as a recourse liability under section 752, and X would have a 100% "share" of the liability under Regulation section 1.707-5(a)(2) since he would bear the risk of loss for the full amount of the liability. Then, since the entire liability would be allocable under Regulation section 1.163-8T to a distribution made by the partnership to X made within 90 days of the partnership incurring the liability, X's "allocable share" of the liability under Regulation section 1.707-5(b)(2) would be equal to his $1,000,000 "share" under Regulation section 1.707-5(a)(2).[46] Thus, X would receive the full $1,000,000 as a tax-free distribution.

A. Guarantees by Undercapitalized Entities: *Canal Corporation*

In *Canal Corporation v. Commissioner*,[47] the Tax Court held that an indemnity of a guarantee of partnership debt made by a partner was not respected for purposes of determining the partner's share of the debt under the debt-financed distribution rules. In this case, Chesapeake was the common parent of an affiliated group that included Wisconsin Tissue Mills, Inc. ("WISCO"), a manufacturer of commercial tissue paper products. Chesapeake and Georgia Pacific ("GP"), which also had a tissue paper business, entered into a transaction in which both WISCO and GP transferred their tissue paper businesses to a joint venture (the "LLC"). Then, the LLC borrowed $755 million and distributed all $755 million to WISCO in redemption of approximately 97% of WISCO's interests in the LLC in what was designed to qualify as a tax-free debt-financed distribution. GP guaranteed the debt, but WISCO provided GP with an indemnity so that WISCO would be considered to bear the risk of loss for the debt and the debt would be allocated in its entirety to WISCO. After the transaction, the assets retained by WISCO (which included only a $151 million intercompany note and a $6 million corporate jet) were worth 21% of the value of its $755 million exposure on the indemnity. WISCO's potential indemnity obligation was limited in that (1) WISCO indemnified only GP's guarantee to pay the principal (but not the interest) and (2) GP would be required to proceed against the LLC's assets prior to demanding indemnification from WISCO.

Chesapeake received a tax opinion from PwC which concluded that WISCO's receipt of the $755 million distribution "should" be tax-free as a debt-financed distribution and should not be treated as part of a sale. On audit, the IRS determined that the transaction constituted a sale and assessed a substantial understatement penalty. In holding for the IRS, the Tax Court noted that the anti-abuse rules of Regulation section 1.752-2(j) provide that a partner's obligation to make a payment may be disregarded if (1) the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's risk of loss or to create a facade of the partner's bearing the economic risk of loss with respect to the obligation, or (2) the facts and circumstances of the transaction evidence a plan to circumvent or avoid the obligation.[48] Therefore, the Tax Court explained, "we must review the facts and circumstances to determine whether WISCO's indemnity agreement may be disregarded as a guise to cloak WISCO with an obligation for which it bore no actual economic risk of loss."

The Tax Court determined that Chesapeake structured the indemnity agreement in order to minimize the possibility that WISCO would ever have any liability under the agreement. In addition, the Tax Court noted that Chesapeake could cancel the intercompany note at any time, at which point WISCO would have virtually no assets. It determined that the indemnity agreement "created no more than a remote possibility that WISCO would actually be liable for payment" and "afforded no real protection to GP."[49] The Tax Court concluded that WISCO "had no economic risk of loss" and "used the indemnity to create the appearance that WISCO bore the economic risk of loss for the LLC debt when in substance the risk was borne by GP."[50] Therefore, the Tax Court ignored the indemnity agreement, and all of the debt was allocated to GP since GP had guaranteed the debt and in substance the risk was borne by GP. Accordingly, no portion of the $755 million distributed to WISCO qualified as a tax-free debt-financed distribution.

Although the Tax Court's decision in *Canal Corporation* seems to demonstrate a general hostility toward the whole concept of tax-free debt-financed distributions, its holding appears to be more narrowly based on the fact that the indemnity agreement was crafted in a manner that violated an explicit anti-abuse provision. As a result, it appears that *Canal Corporation* does not reflect a change in the man-

ner in which the courts will allocate debt in general under section 752 or section 707. It is true that *Canal Corporation* should provide a note of caution for a taxpayer that is contemplating having a thinly capitalized entity guarantee debt for purposes of receiving a debt-financed distribution. However, the Tax Court's decision in *Canal Corporation* should not prevent a taxpayer's guarantee from being respected for purposes of determining a taxpayer's share of debt under Regulation section 1.707-5(a)(2) if the guarantee is not disregarded under an anti-abuse rule.

B. Debt-financed Distributions Accomplished by Refinancing an Encumbered Property

Suppose that a partnership desires to obtain the funds for a debt-financed distribution by refinancing an already encumbered property. For example, suppose that a partnership wants to make a $500,000 tax-free debt-financed distribution to a partner, and the partnership has a property with a $2,000,000 value that is already subject to $500,000 of debt. The partnership could obtain $1,000,000 in a refinancing of the property, use $500,000 to repay the old debt, and distribute the remaining $500,000 to the partner in the debt-financed distribution. However, if the partner guarantees only $500,000 of this new debt, then the partner's "allocable share" under Regulation section 1.707-5(b)(2) would be only $250,000 -- that is, the partner's $500,000 share of the debt under Regulation section 1.707-5(a)(2) times the fraction obtained by dividing (1) the $500,000 portion of the debt that is allocable under section 1.163-8T to the distribution to the partner by (2) the $1,000,000 total amount of the liability.[51] This would mean that the partnership would be considered to transfer $250,000 to the partner which would be considered to be received as part of a disguised sale under Regulation section 1.707-3.

C. Debt-Financed Distributions Accomplished Without the Partner Guaranteeing Debt

Suppose that a partner wants to receive a transfer of cash from a partnership as a tax-free debt-financed distribution in its entirety, but the partner does not want to guarantee the new partnership liability. If the liability is a nonrecourse liability, the partner's "share" of the liability under Regulation section 1.707-5(a)(2) would be a percentage equal to his share of the partnership's "excess nonrecourse liabilities" under Regulation section 1.752-3(a)(3). Although a partner's share of "excess nonrecourse liabilities" is generally determined in accordance with the partner's share of partnership profits, Regulation section 1.752-3(a)(3) provides that "[t]he partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain." To illustrate a possible way in which a partner could take advantage of this provision for purposes of structuring a debt-financed distribution, consider the following example.

Example 7

Facts: A partnership agreement provides that the partnership's first $1,000,000 of gross income is allocated 100% to one partner (X), and that further gross income is allocated in accordance with the partners' participation percentages. Assume that these allocations have substantial economic effect. X contributes a property with a value of $5,000,000 to the partnership, and the partnership incurrs

$2,000,000 of nonrecourse debt and distributes $2,000,000 of cash to X in what is intended to qualify as a debt-financed distribution.

Analysis: It would seem that the allocation of the first $1,000,000 of income to X would be considered to be "allocations (that have substantial economic effect under the section 704(b) regulations) of [a] significant item of partnership income or gain" within the meaning of Regulation section 1.752-3(a)(3). If so, then all of the excess nonrecourse liabilities could permissibly be allocated to X and X would have a 100% "share" of the $2,000,000 partnership liability under Regulation section 1.707-5(a)(2) for purposes of the debt-financed distribution provisions. Since all of the proceeds of the borrowing would be allocable under Regulation section 1.163-8T to the money that is transferred to X, it appears that X would have a $2,000,000 allocable share of the liability and that X's receipt of the entire $2,000,000 would constitute a tax-free debt-financed distribution.

Yet, in both CCA 200513022 and TAM 200436011, the IRS considered a transaction that was structured similarly (although all of the numbers were redacted, so it is impossible to know the preference amount) and came to the opposite conclusion. The CCA stated that "[t]o consider a single allocation of a preferred return, in isolation" as a significant item of partnership income or gain "does not encompass this concept of sharing in a significant economic item of partnership income or gain" and that the allocation of the preferred return "did not reflect the overall economic relationship among the parties for that item of partnership gain." The TAM reached the same conclusion, explaining that the reference in Regulation section 1.752-3(a)(3) to "a significant item of partnership income or gain" looks to "a significant class of partnership income or gain," such as "gain from the sale of property or tax-exempt income," rather than to a "traunch of bottom-line gross or net income."

However, the reasoning of the CCA and the TAM appears to be directly in conflict with an example in Regulations relating to nonrecourse deductions. Regulation section 1.704-2(e) provides that allocations of nonrecourse deductions are deemed to be in accordance with the partners' interests in the partnership only if certain requirements are satisfied. One of these requirements is that the partnership agreement provides for allocations of nonrecourse deductions in a manner that "is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities"[52] (i.e., language that is nearly identical to that of Regulation section 1.752-3(a)(3)).

Regulation section 1.704-2(m), Example 1(ii), considers a situation where two partners (A and B) form a partnership and buy property with nonrecourse debt. The partnership agreement allocates all items 90% to A / 10% to B, until the point in time when cumulative losses are equal to cumulative income and gain, after which the partnership allocates all items 50% to A / 50% to B. The Example concludes that nonrecourse deductions which are allocated in any ratio between (i) 90% to A / 10% to B and (ii) 50% to A / 50% to B will have substantial economic effect because the allocations would be made in a manner that is consistent with "some other significant partnership item attributable to the property securing the nonrecourse liabilities." The Example does not require that, in order to have a "significant item of partnership income or gain," the item must reflect the overall economic relationship among the parties or represent a "class" of income.[53] Thus, the interpretation of Regulation section 1.752-3(a)(3) that is made in both CCA 200513022 and TAM 200436011 is seemingly in conflict with the Regulations' understanding of the nearly identical language used with respect to the allocation of nonrecourse deductions. Never-

theless, this IRS guidance, together with the IRS's position in *Canal Corporation*, reflects a hostility of the IRS toward these transactions.

V. Reimbursement of Capital Expenditures

Regulation section 1.707-4(d) provides taxpayers with another useful exception to the disguised sale rules. This provision states that a transfer of money or other consideration by a partnership to a partner is not treated as part of a disguised sale of property to the extent that the transfer is made to reimburse the partner for, and does not exceed the amount of, certain capital expenditures. In order for the capital expenditures to qualify for this provision, they must (1) have been incurred during the two-year period preceding the transfer by the partner to the partnership[54] and (2) have been incurred by the partner with respect to either:

(A) Partnership organization and syndication costs described in section 709; or

(B) Property contributed to the partnership by the partner -- but only to the extent that the reimbursed capital expenditures do not exceed 20% of "the fair market value of such property" at the time of the contribution (the "20% Limitation"). The 20% Limitation, though, does not apply if "the fair market value of the contributed property" does not exceed 120% of the partner's adjusted basis in the contributed property at the time of contribution (the "120% Safe Harbor").[55]

The following example provides a simple illustration of the operation of the 20% Limitation and 120% Safe Harbor.

Example 8

Facts: X transfers to a partnership an unencumbered property with a $1,200,000 value and a $1,000,000 basis. X made a $750,000 capital expenditure with respect to the property in the previous two years. The partnership simultaneously transfers $500,000 of cash to X.

Analysis: A distribution by the partnership to X of up to $750,000 could be excluded from being treated as being made pursuant to a disguised sale as a reimbursement of capital expenditures, since X made $750,000 of capital expenditures with respect to the property in the previous two years. Since the $1,200,000 value of the contributed property does not exceed 120% of X's $1,000,000 basis in the property (which is exactly equal to $1,200,000), the 120% Safe Harbor is satisfied and the 20% Limitation is inapplicable.[56] Therefore, the entire $500,000 distribution to X is excluded from being treated as part of a disguised sale as a reimbursement of capital expenditures.

While the reimbursement of capital expenditures provision can be a useful tool for enabling a partner to avoid disguised sale treatment under certain circumstances, there are various ambiguities with respect to the operation of this provision, and the Regulations unfortunately do not provide any examples. The IRS acknowledged in 2004 that it was aware of "deficiencies and technical ambiguities" with respect to the rules for capital expenditure reimbursements and the interaction of the capital expenditure reimbursement rules with the qualified liability rules; and that, to address these issues, the IRS and Treasury intended to issue proposed regulations amending the existing regulations.[57] However, no such

proposed regulations have been issued. It would appear (or one would hope) that the following are among the issues of which the IRS spoke.

A. Gross Fair Market Value or Net Fair Market Value?

Where the contributed property is subject to debt, the provision does not specify whether "fair market value" (as used in the 20% Limitation and 120% Safe Harbor) means *gross* value or *net* value. To illustrate the implications of this distinction, consider the following example.

Example 9:

Facts: X transfers to a partnership a property with a gross value of $1,000,000 that is subject to $500,000 of debt and, simultaneously, the partnership transfers $150,000 of cash to X. X acquired the property in the previous two years and has a $550,000 basis in the property.

Analysis: Since the property has a gross value of $1,000,000 and a net value of $500,000, the 20% Limitation amount would be set at either $200,000 or $100,000, depending on whether the limit refers to gross value or net value. The 120% Safe Harbor provides that the 20% Limitation does not apply if "the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property." Since basis generally includes liabilities, it appears that "fair market value" in this context would have to be understood to refer to gross value (i.e., which also includes liabilities). This would mean that the 120% Safe Harbor would not be satisfied in the above example, since 120% of basis ($660,000 -- that is, the $550,000 basis multiplied by 120%) is less than the gross value of the property (i.e., $1,000,000). The other theoretical possibility, that the 120% Safe Harbor would be satisfied if the *net* fair market value does not exceed 120% of basis (such that, in this example, the 120% Safe Harbor would be satisfied since 120% of basis ($660,000) exceeds the $500,000 net fair market value), seems to be a taxpayer-friendly result that would not make sense since basis *includes* liabilities.

Thus, it appears that "fair market value" must refer to gross fair market value for purposes of the 120% Safe Harbor. Since it seems inconceivable that the phrase "fair market value" would mean two different things in successive sentences in the same subsection, the best reading of the Regulations seems to be that the 20% Limitation limits the reimbursement of capital expenditures to 20% of the *gross* value of the property. In the above example, this would mean that all $150,000 of the cash transferred to the partner would be excluded from being part of a disguised sale under the reimbursement of capital expenditures exception.[58]

Yet, consider a transaction where a partner contributes to a partnership property with a gross value of $100,000,000 subject to $75,000,000 of nonrecourse debt that constitutes a qualified liability, with a basis of $30,000,000 and then the partnership transfers $20,000,000 of cash to the partner. The partner made $20,000,000 of capital expenditures with respect to the property in the previous two years. The partner has a 1% share of the debt after this transaction. Assuming that the 20% Limitation limits reimbursements to 20% of the $100,000,000 gross value of the contributed property (i.e., $20,000,000), the entire $20,000,000 distribution to the partner would qualify as a reimbursement of capital expenditures and would be a tax-free distribution. In light of the fact that the partnership would be assuming the $75,000,000 qualified liability tax-free, one might have thought that the 20% Limitation would limit the amount qualifying as a reimbursement of capital expenditures to 20% of the net value of $25,000,000.[59]

However, as noted above, it appears that the best reading of the Regulations is that the 20% Limitation is based on 20% of gross value.

B. What is "Such Property"?

Regulation section 1.707-4(d) provides that the reimbursement of capital expenditures exception to the disguised sale rules applies with respect to capital expenditures that "are incurred by the partner with respect to… property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of *such property* at the time of the contribution."[60] To what property does "such property" refer? One possibility seems to be that it refers to all property contributed by the partner as part of the transaction (i.e., even property to which capital expenditures were not made in the previous two years). Alternatively, it seems that "such property" could refer only to the property to which the capital expenditures were made. The following example illustrates this distinction.

Example 10:

Facts: X contributes one property with a value of $2,000,000 (Property A) and another property with a value of $8,000,000 (Property B). For simplicity, assume that neither property is subject to any debt. In the previous two years, X incurred $2,000,000 of capital expenditures with respect to Property A and no capital expenditures with respect to Property B. X receives a $2,000,000 distribution from the partnership.

Analysis: If "such property" refers to all property that is contributed to the partner as part of the transaction, then the amount of the 20% Limitation would be set at $2,000,000 (i.e., 20% of the $10,000,000 value of all property contributed). Therefore, the entire $2,000,000 distribution would be excluded from disguised sale treatment. Alternatively, if "such property" refers only to the property to which the capital contribution was made, then the amount of the 20% Limitation would be set at $400,000 for Property A (20% of the $2,000,000 value of this property) and $0 for Property B (since no capital expenditures were made to this property in the previous two years). Thus, only $400,000 of the $2,000,000 distribution would excluded from disguised sale treatment. It is not clear from the wording of the Regulations which understanding of "such property" is correct.[61]

C. Disclosure Requirement

The Disguised Sale Regulations are explicit that no disclosure is required where, within a two-year period, a partner contributes property to a partnership and the partnership distributes money to the partner if the distribution to the partner qualifies as a guaranteed payment for capital, reasonable preferred return, or operating cash flow distribution.[62] However, the Disguised Sale Regulations do not include an exception to the disclosure requirement where the distribution to the partner qualifies under the reimbursement of capital expenditures provision. This distinction seems surprising, particularly since preferred returns and operating cash flow distributions are only *presumed* not to be part of a disguised sale, whereas a reimbursement of capital expenditures is *automatically* excluded from being considered to be part of a disguised sale if the specific requirements of Regulation section 1.707-4(d) are satisfied.[63]

VI. Scope of the Regulations: "Disguised Sale" vs. "Actual Sale"

Could there be circumstances under which a taxpayer wants a transaction to be governed by the Disguised Sale Regulations, but the IRS might contend that the transaction should be recharacterized as an "actual" sale of property under general tax principles instead of being treated as a "disguised" sale of property governed by the Disguised Sale Regulations? To illustrate this distinction, consider again the scenario set forth in Example 8, above, illustrating a reimbursement of capital expenditures. The scenario in Example 8 was the following:

> X transfers to a newly formed partnership an unencumbered property with a $1,200,000 value and a $1,000,000 basis. X made a $750,000 capital expenditure with respect to the property in the previous two years. The partnership simultaneously transfers $500,000 of cash to X.

Could the IRS contend that this disguised sale was "disguised" so poorly that the Disguised Sale Regulations are inapplicable altogether, and the transaction should be treated as an "actual" sale of property under general tax principles? Such a recharacterization of the transaction would prevent X from receiving a tax-free reimbursement of capital expenditures. It seems clear that the IRS would not be justified in making such a contention. The Disguised Sale Regulations serve as a codification of a recharacterization regime, and these Regulations are explicit in their provisions regarding how these transfers should be treated. If the IRS could "opt out" of the Disguised Sale Regulations in favor of general recharacterization principles, the purpose of these Regulations would be undermined and the result would be an untenable situation in which taxpayers would never be able to know whether the Disguised Sale Regulations would apply to a transaction.

Suppose that the partnership is a newly formed partnership and that the $500,000 of cash that is distributed to X were contributed to the partnership by another partner (Y) at the same closing. Could the IRS now contend that the transaction should be characterized such that X is considered to sell 5/12 of the property (i.e., the $500,000 of cash received by Y divided by the $1,200,000 value of the property) to Y in an "actual" sale for $500,000, and then X and Y contribute their respective shares of the property to the partnership? This characterization would again preclude X from receiving the tax-free reimbursement of capital expenditures. It seems that, although introducing Y into the transaction adds an additional layer of complexity, the result still has to be that the transaction is governed by the Disguised Sale Regulations. Otherwise, one would again run into the absurdity of the IRS recharacterizing a recharacterization that already is explicitly called for in the Regulations.

VII. Conclusion

Prior to the promulgation of the Disguised Sale Regulations, there was a dearth of guidance relating to the circumstances under which related transfers between a partner and a partnership should be treated as a sale or exchange of property. Although the Disguised Sale Regulations include a facts and circumstances test that is based on a generally unhelpful lengthy list of 10 factors, they include numerous detailed provisions that govern whether, and the extent to which, a transaction will be treated as a disguised sale of property. This can be unfortunate for taxpayers in that these rules are often restrictive and include numerous traps for the unwary. At the same time, though, the Disguised Sale Regulations provide taxpayers not only with the benefits that come from having certainty in knowing how these trans-

actions will be treated for tax purposes, but also with planning opportunities that can be taken advantage of. Thankfully, although certain issues with respect to the Disguised Sale Regulations remain unclear, the presumptions and safe harbors of the Regulations have largely taken this area out of the facts and circumstances morass in which so many areas of tax law are mired.

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[1] Section references are to the sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[2] Regulation section 1.721-1(a), also promulgated in 1956, includes a similar provision with respect to the applicability of section 721.

[3] H.R. Rep. No. 432, 98th Cong., 2d Sess., 1218 (1984), citing *Otey v. Commissioner*, 70 T.C. 312 (1978), *aff'd per curiam* 634 F.2d 1046 (6th Cir. 1980); *Communications Satellite Corp. v. United States*, 223 Ct. Cl. 253 (1980); *Jupiter Corp. v. United States*, 2 Ct. Cl. 58 (1983).

[4] This article focuses only on the rules related to disguised sales of property between a partner and a partnership. Section 707(a)(2)(B) also governs disguised sales of partnership interests (i.e., a transfer of money or other property by a partner to a partnership and a related transfer of money or other property by the partnership to another partner). The Disguised Sale Regulations, as promulgated in 1992, did not include provisions with respect to disguised sales of partnership interests. In 2004, the IRS finally released proposed regulations related to disguised sales of partnership interests. In general, these proposed regulations attempted to take an approach similar to that of the Disguised Sale Regulations with respect to disguised sales of property. The disguised sale of partnership interest proposed regulations were widely criticized by commentators as causing numerous transactions to be improperly treated as a disguised sale of partnership interests. *See, e.g.*, Richard M. Lipton, "Controversial Prop. Regs. on Disguised Sales of Partnership Interests -- IRS Jumps Into the Deep End," 102 Journal of Taxation No. 2, 71 (2005); Jeffry L. Rubinger, "Proposed Regulations on Disguised Sales of Partnership Interests," 7 Business Entities No. 3, 6 (2005). The proposed regulations were never finalized, and the Treasury finally relented in 2009 and withdrew the proposed regulations. Ann. 2009-4, 2009-8 I.R.B. 597. There currently is no IRS or Treasury guidance with respect to disguised sales of partnership interests. The announcement withdrawing the proposed regulations states that "[u]ntil new guidance is issued, any determination of whether transfers between a partner or partners and a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law." *Id.*

[5] I.R.C. § 707(a)(2)(B)(iii).

[6] Under Regulation section 1.707-6, rules similar to those provided in Regulation section 1.707-3 apply when determining whether a transfer of property *by a partnership to a partner* and a transfer of money or other consideration *by the partner to the partnership* are treated as a sale of property by the partnership to the partner. For simplicity, the examples discussed in this article will all consider scenarios where it is the partner who is transferring property to the partnership.

[7] For example, suppose that a partner contributes an appreciated property and $1 million of cash to a partnership in exchange for interests in the partnership. Four months later, in the next tax year, the partnership returns $250,000 of the cash to the partner pursuant to a post-transaction true-up based on a calculation set forth in the contribution agreement. This transaction that would appear to satisfy the two conditions of Regulation section 1.707-3(b)(1) for having a disguised sale, but would not appear to be "properly characterized as a sale or exchange of property."

[8] As a further support for this reading of the Regulations, it appears that the ten relevant facts and circumstances set forth in paragraph (b)(2) do not exclusively relate to the two conditions of paragraph (b)(1). For example, the last of these facts and circumstances is "[t]hat 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." Treas. Reg. § 1.707-3(b)(2)(x). Whether or not a partner is obligated to return a cash distribution goes to the question of whether transfers are properly characterized as a disguised sale -- but does not seem to have any specific bearing on either the "but-for condition" or the "entrepreneurial risk" condition of paragraph (b)(1).

[9] It appears that the language in paragraph (a)(1), that transfers described in paragraph (b)(1) are treated as a disguised sale "except as otherwise provided," could be compatible with this reading of the Disguised Sale Regulations -- the "except as otherwise provided" could be understood to include an exception for a circumstance where both of the conditions in paragraph (b)(1) are satisfied, but there nonetheless is not a disguised sale based on all of the facts and circumstances under paragraph (b)(2).

[10] Treas. Reg. § 1.707-3(c)(1).

[11] Treas. Reg. § 1.707-3(c)(2). The IRS included a provision in 2004 proposed regulations (relating primarily to disguised sales of partnership interests) which would have increased this disclosure period from two years to seven years. The preamble to these proposed regulations explained that a Joint Committee report had recommended that the disclosure period be increased beyond two years and "suggested that expanding the disclosure period to seven years might make it more likely that taxpayers would undertake the facts and circumstances determination for transfers occurring more than two years apart and would make that facts and circumstances determination easier for the IRS to administer." The preamble requested comments regarding whether the disclosure requirement should be extended to a period between two and seven years. As noted above, these proposed regulations were never finalized, and were withdrawn in 2009 amid heavy criticism. *See* Ann. 2009-4, 2009-8 I.R.B. 597.

[12] Treas. Reg. § 1.707-3(c)(2).

[13] There is only limited case law applying the facts and circumstances test to determine whether transfers constitute a disguised sale of property. For two recent cases, see *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, 107 AFTR 2d 2011-1523 (4th Cir. 2011), rev'g T.C. Memo 2009-295 (holding that the contribution of cash by partners to a partnership and the distribution of State tax credits by the partnership to the partners constituted a disguised sale of property by the partnership to the partners); and *G-I Holdings, Inc. v. Commissioner*, 105 AFTR 2d 2010-697 (D.N.J. 2009) (unpublished decision finding, in dictum, that a contribution of property to a partnership and a loan made by the partnership to the partner constituted a disguised sale of property by the partner to the partnership).

[14] *See* Treas. Reg. § 1.707-4(a)(1).

[15] *See* Treas. Reg. § 1.707-4(a)(2).

[16] *See* Treas. Reg. § 1.707-4(b).

[17] *See* Treas. Reg. § 1.707-4(d).

[18] *See* Treas. Reg. § 1.707-5(b). The exceptions related to reimbursements of capital expenditures and debt-financed distributions will be discussed in depth herein.

[19] Treas. Reg. § 1.707-3(a)(2).

[20] *Id.*

[21] *Id.* The Regulations provide that, in general, the facts and circumstances existing on the date of the *earliest* of the transfers in question are the ones that are considered in determining whether there is a disguised sale. Treas. Reg. § 1.707-3(b)(2). If the transfer of property by the partner to the partnership is made before the transfer of money or other consideration by the partnership to the partner, then the relevant facts and circumstances would be those as of the date on which the disguised sale is considered to occur (i.e., the date of the transfer of the property to the partnership). In contrast, if the partnership transfers the money or other consideration to the partner before the partner transfers property to the partnership, then the relevant facts and circumstances would be those as of the date of the partnership's transfer of money or other consideration -- which would be prior to the date on which the disguised sale is considered to occur (i.e., the date of the transfer of the property to the partnership).

[22] *See* Treas. Reg. 1.707-3(f), Example 1.

[23] Treas. Reg. § 1.707-5(a)(6)(i). If an assumed liability is a recourse liability, the amount of the liability which constitutes a qualified liability may not exceed the fair market value of the transferred property at the time of the transfer. Treas. Reg. 1.707-5(a)(6)(ii).

[24] Treas. Reg. § 1.707-5(a)(6)(i)(A).

[25] Treas. Reg. § 1.707-5(a)(6)(i)(B). There is a presumption that, if within a two-year period a partner incurs a liability and transfers property to a partnership, and the partnership assumes or takes subject to the liability as part of the transfer, the liability was incurred in anticipation of the transfer unless "the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer." Treas. Reg. § 1.707-5(a)(7)(i). This presumption would have to be rebutted in order for a liability to be considered to be a qualified liability under Regulation section 1.707-5(a)(6)(i)(B). Also, a disclosure is required if a liability is treated as a qualified liability under Regulation section 1.707-5(a)(6)(i)(B). Treas. Reg. § 1.707-5(a)(7)(ii).

[26] Treas. Reg. § 1.707-5(a)(6)(i)(C). Interesting questions arise with respect to capital contributions made to entities when interests in such entities are then contributed to a partnership.

[27] Treas. Reg. § 1.707-5(a)(6)(i)(D).

[28] Treas. Reg. § 1.707-5(a)(1).

[29] Treas. Reg. § 1.707-5(a)(2)(i).

[30] Treas. Reg. § 1.707-5(a)(2)(ii). Regulation section 1.752-3(a)(3) provides that a partner's share of "excess nonrecourse liabilities" (i.e., nonrecourse liabilities which are not allocated under either section 1.752-3(a)(1) or section 1.752-3(a)(2)) is "determined in accordance with the partner's share of partnership profits." A partner's share of partnership profits is generally determined by taking into account all of the facts and circumstances, but the Regulations provide that the partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities in any manner such that "the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain." Treas. Reg. § 1.752-3(a)(3). Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner "in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated." If the partnership uses one of these alternative methods for purposes of section 752, this method apparently would apply for disguised sale purposes as well.

In addition, Regulation section 1.752-3(a)(3) provides that excess nonrecourse liabilities may first be allocated to a partner up to the amount of built-in gain that is allocable to the partner with respect to "section 704(c) property" that is subject to a nonrecourse liability, to the extent that that the built-in gain exceeds the amount of gain described in Regulation section 1.752-3(a)(2). ***However***, the Regulations provide that this method of liability allocation cannot be used for purposes of determining a partner's share of "excess nonrecourse liabilities" for purposes of the disguised sale rules.

[31] *See* Treas. Reg. § 1.707-5(f), Example 1.

[32] The partnership would have a basis of $250,000 (with a new holding period) in the portion of the property that is considered to be sold, and would have a carryover basis (with a "tacked" holding period) of $300,000 in the portion of the property that is considered to be contributed to the partnership under section 721 (i.e., carryover basis for the 75% of the property that is considered to be contributed).

[33] Treas. Reg. § 1.707-5(a)(5)(i).

[34] *Id*.

[35] Treas. Reg. § 1.707-5(a)(5)(i).

[36] Treas. Reg. § 1.707-5(a)(5)(ii).

[37] X would have the same $120,000 of gain if the example were changed such that the partnership transferred $100,000 of cash to X and took the property subject to only the qualified liability (but not subject to the nonqualified liability).

[38] However, the two-part "lesser of" test of the Regulations seems to be an imprecise method of achieving this result.

[39] *See* Treas. Reg. § 1.708-1(c)(1).

[40] *See* Treas. Reg. § 1.708-1(c)(3)(i).

[41] *See* W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, ¶ 14.02[3][b][vi] (Warren, Gorham & Lamont, 3d ed. 1997) (hereafter cited as "McKee Nelson"), which states that the above result is "clearly dictated by the Regulations" but "is probably unintended and may be a trap for the unwary in some situations."

[42] As described above, if a partner contributes a property to a partnership subject to a nonqualified liability, the partnership would be considered to transfer consideration to the partner only to the extent of the excess of the amount of the liability over the partner's share of the liability immediately after its assumption. The basic idea of the debt-financed distribution rules is to put the partner in the same situation where it is the partnership that incurs the liability.

[43] Treas. Reg. § 1.707-5(b)(1).

[44] If the distribution is made by the partnership within 30 days of the new borrowing, the liability would automatically be allocable under Regulation section 1.163-8T to the distribution even in the absence of tracing. (Regulation section 1.163-8T(c)(5)(i) provides that, if a taxpayer receives the proceeds of a debt in cash, the taxpayer may treat any cash expenditure made within 15 days after receiving the cash as made from such debt proceeds to the extent thereof. Notice 89-35 extends this period to 30 days.)

[45] X's "allocable" share of the liability would be equal to his $250,000 "share" of the liability multiplied by 100% -- that is, the fraction obtained by dividing (1) the $1,000,000 portion of the liability that is allocable under Regulation section 1.163-8T to the money transferred to X by (2) the $1,000,000 total amount of the liability.

[46] X's "allocable" share of the liability would be equal to his $1,000,000 "share" of the liability multiplied by 100% -- that is, the fraction obtained by dividing (1) the $1,000,000 portion of the liability that is allocable under Regulation section 1.163-8T to the money transferred to X by (2) the $1,000,000 total amount of the liability.

[47] 135 T.C. 199 (2010).

[48] *Id.*, citing Treas. Reg. § 1.752-2(j)(1), (3).

[49] *Id.* at 214; 216.

[50] *Id.* at 216-17.

[51] It may be possible to contend that this new debt should be treated as two separate liabilities under a rule in the Disguised Sale Regulations related to the treatment of refinancing debts. Specifically, Regulation section 1.707-5(c) provides that a debt that is used to repay a previously existing debt is treated as the original debt for purposes of the Disguised Sale Regulations. Under this provision, the $500,000 portion of the new debt that is used to repay the original debt would be treated as the same debt as the original debt. Then, since the excess proceeds would seem to be distinct from the original debt, it would seem that one might be able to contend that it follows that the $500,000 portion of the new debt from which the excess proceeds are obtained must be a separate debt. If so, then 100% of this $500,000 debt would be allocable under Regulation section 1.163-8T to the money distributed to the partner. However, even if this logic were accepted, there would not appear to be a way for the partner to ensure that he is guaranteeing only the debt that is used to fund the distribution. Assuming that the partner is considered to guarantee a pro rata 50% of each of the two $500,000 liabilities, he would have only a $250,000 "share" under Regulation section 1.707-5(a)(2) of the debt that is used to fund the distribution. His "allocable share" under Regulation section 1.707-5(b)(2) of this debt would also be $250,000 -- the same result as described in the above text assuming that the new debt is treated as a single liability.

[52] Treas. Reg. § 1.704-2(e)(2).

[53] *See, also,* Treas. Reg. § 1.704-2(m), Example 1(i).

[54] Consider a partner that first makes a contribution of property to a partnership and then, two years later, the partnership distributes cash to the partner. Any capital expenditures that the partner makes in the two years prior to the contribution of property to the partnership would qualify under the reimbursement of capital expenditures provision -- notwithstanding the fact that this would be four years before the distribution of cash from the partnership to the partner.

[55] Treas. Reg. § 1.707-4(d). It appears that capital expenditures "incurred by the partner with respect to… property contributed to the partnership by the partner" would include capital expenditures incurred either (1) with respect to property owned by the partner or (2) in order to acquire the property.

[56] If the 120% Safe Harbor were inapplicable, the 20% Limitation would limit the tax-free distribution to $240,000 (i.e., 20% of $1,200,000).

[57] 69 Fed. Reg. 68,838 (2004).

[58] It appears that, where the contributed property is partnership interests, the same logic should apply and fair market value should be understood to refer to gross value. This would mean that the "fair market value" of partnership interests would mean the share of the gross value of the underlying partnership property that is allocable to the partnership interests.

[59] This point would seem to be strengthened even further if the $20,000,000 of capital expenditures were made with funds from the qualified liability.

[60] Emphasis added.

[61] It appears that if "such property" refers only to property to which qualifying capital expenditures were made, the 20% Limitation would be applied on a property-by-property basis in a case where multiple properties to which qualifying capital expenditures were made are contributed. To illustrate, suppose that, in the above example, X had incurred $1,000 of capital expenditures with respect to Property B in the previous two years. If the 20% Limitation were applied on a property-by-property basis, then X could receive $401,000 as a reimbursement of capital expenditures (i.e., $400,000 that is capped by the 20% Limitation on Property A and all $1,000 of capital expenditures for Property B). Alternatively, a perhaps less plausible reading of the Regulations is that the 20% Limitation is applied in the aggregate to all property to which at least *some* qualifying capital contribution was made -- which would mean that X could receive the entire $2,000,000 distribution as a reimbursement of capital expenditures since the aggregate 20% Limitation amount would be set at $2,000,000.

[62] Treas. Reg. § 1.707-3(c)(2).

[63] McKee Nelson, ¶ 14.02[3][b][ix], states: "Notably absent from the list of exempted distributions are those that are reimbursements for pre-formation capital expenditures. It seems illogical to require disclosure of amounts that are not treated as part of a disguised sale while not requiring disclosure for preferred returns and operating cash flow distributions that are only presumed to not be part of a disguised sale, but it is difficult to conclude otherwise." Note, though, that the Regulations do not specify what the penalty would be for failing to satisfy the disclosure requirement for disguised sales when applicable.