Partnership Distributions: Avoiding Tax Traps of Mixing Bowl Transactions, Disguised Sales, and 751(b)
Gaining Insight Into the Complex Tax Concepts Through Real World Examples

WEDNESDAY, SEPTEMBER 18, 1:00-2:50 pm Eastern

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Partnership Distributions: Avoiding Tax Traps of Mixing Bowl Transactions, Disguised Sales, and 751(b)

Sept. 18, 2013

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Today’s Program

Navigating 751(b)  
[Bruce Belman]  

Mixing Bowl Transactions  
[Thomas Hausman]  

Disguised Sales Controversies  
[David Blair]  

Slide 7 - Slide 52  
Slide 53 - Slide 93  
Slide 94 - Slide 115
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Bruce Belman, Crowe Horwath

NAVIGATING SECTION 751(b)
Help! I need somebody…
Navigating Section 751(b)
Topics

- Current & Liquidating Distributions
- Section 751(b)
- Basis Adjustments
- Pitfalls
Current & Liquidating Distributions

The Internal Revenue Code is absurdly complex or, as we lawyers say, a goldmine.
Current Distributions

- **Defined** – any distribution if, after the distribution, the partner remains a partner
- **Gain or loss recognition**
  - Generally, no gain or loss is recognized on current distribution.
  - Exception: Gain is recognized if amount of cash distributed exceeds partner’s basis in interest.
- **Basis**
  - Distributee partner - generally takes distributed property with a carryover basis, but can never take partnership property with higher basis than their basis in partnership.
  - Distributee partner - Partnership basis reduced by basis taken in property distributed.
Liquidating Distributions

- **Defined**: any distribution if, after the distribution, the partner does not remain a partner.

- **Gain or loss recognition**
  - Generally, no gain or loss is recognized on liquidating distribution.
  - Partner recognizes gain if amount of cash distributed exceeds partner’s basis in interest.
  - Partner recognizes loss *if*
    - Only cash, unrealized receivables and/or inventory are distributed, and
    - Amount of money and inside basis of assets distributed is less than distributee partner's outside basis.

- **Basis**
  - Basis in distributed property equals adjusted basis of distributee partner’s interest in partnership, reduced by any cash received in same transaction.
Adjusting a Partner’s Basis for Distributions

- Liquidating distributions
  - The partner’s basis in the distributed property is equal to the partner’s adjusted basis in his partnership interest immediately before the distribution.
Allocation of Basis – Sec. 732(c)

- Where multiple properties are distributed, basis shall be allocated:
  - First to any unrealized receivables and any inventory items in an amount equal to the adjusted basis of each such property to the partnership.
    - If the basis of the distributee’s interest in the partnership is less than the basis of the above items, allocate decrease in accordance with shortfall rules discussed below.
  - If there is any basis remaining, allocate to all other properties:
    - First, by assigning to such other property the basis it had in the partnership, and
    - Then, to the extent any increase or decrease in basis is required in accordance with the methods discussed below.
Special Basis Adjustment – Sec. 754 election not in effect

- A transferee partner can elect under Sec. 732(d) to adjust the basis of property distributed from the partnership within 2 years of acquiring the interest as if a Sec. 743 adjustment had been made.
Excess Basis or Shortfall

- **Basis shortfall**
  - First, allocate any basis shortfall to properties with unrealized depreciation in proportion to the respective amount of unrealized depreciation.
  - Second, allocate any additional shortfall in proportion to the adjusted basis of the properties in the hands of the partnership as previously adjusted.

- **Excess basis**
  - First, allocate to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase; and
  - Then in proportion to their respective fair market values.
Liquidating Distribution Example

Partner’s outside basis = $30,000
Partnership distributes cash of $3,000
Inventory with a basis of $5,000
Musical equipment, with a basis of $2,000

The musical equipment consists of:

Drums, FMV $3,000, basis $1,500
Guitar, FMV $1,000, basis $500.

First Basis is reduced for the cash distributed and inventory distributed:

Partner’s Basis Before Distribution ..................$ 30,000
Cash Distributed.................................................. (3,000)
Inventory Distributed.......................................... (5,000)
Basis to be allocated to Musical Equipment......... $ 22,000
### Liquidating Distribution Example

#### Summary of basis in musical equipment received:

<table>
<thead>
<tr>
<th></th>
<th>Drums</th>
<th>Guitar</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Basis</td>
<td>$1,500</td>
<td>$500</td>
</tr>
<tr>
<td>Unrealized Appreciation</td>
<td>$1,500</td>
<td>$500</td>
</tr>
<tr>
<td>Proportion to FMV</td>
<td>$13,500</td>
<td>$4,500</td>
</tr>
<tr>
<td>Total</td>
<td>$16,500</td>
<td>$5,500</td>
</tr>
</tbody>
</table>
Section 751(b)
Hot Assets-IRC Section 751(b)

- Sec. 751(b) is one exception to the general rule that gain or loss is not recognized upon the distribution of money or property.

- Sec. 751(b) applies when the partnership owns “ordinary income property” (cash method accounts receivable and substantially appreciated inventory), and in a distribution, the distributee partner receives more or less than his pro-rata share of ordinary income property or capital gain property (including cash).

- Income or gain may be recognized by both the partner and the partnership.

- Gain may also be recognized under the mixing bowl rules.
Hot Assets-IRC Section 751(b)

When is Sec. 751(b) applicable?

- A distribution to a partner,
- Partnership must own two classes of property (hot and non-hot assets), and
- Must be a disproportionate distribution.
Definition of Hot Assets

- Two varieties: unrealized receivables and inventory.
- Unrealized receivables include rights to payments for goods or services rendered or to be rendered and not already included in partnership income, i.e. Cash basis receivables. Also includes depreciation recapture and other items similar to recapture.
Definition of Hot Assets (continued)

Inventory includes:

1. Items held for sale in the ordinary course of a trade or business.

2. Any other asset that if sold generates ordinary income (other than a capital or Sec. 1231 asset).

3. Any other property owned by the partnership, which if held by the distributee partner, would generate ordinary income from the first two categories.
Hot Assets-IRC Section 751(b)

- A distribution is disproportionate to the extent that the distributee’s share of “hot assets” increases or decreases relative to other partnership assets.

- For purposes of Sec. 751(b), inventory must be “substantially appreciated”, meaning FMV of inventory exceeds 120% of adjusted basis of inventory.

- If the 120% test is met, then all of the inventory items are treated as Sec. 751 property.

- Treated as a deemed taxable exchange between the partnership and the distributee.
Hot Assets-IRC Section 751(b)

If Sec. 751(b) applies, then:

- The distributee partner may recognize gain or loss;
- The gain or loss may be ordinary income or loss, whereas gain under the general rule of Sec. 731 is capital;
- The partnership may recognize gain or loss;
- The partnership’s adjusted basis for its property may change.
Hot Assets-IRC Section 751(b)

Four Steps:

1. Identify Sec. 751 assets.

2. Hypothetical distribution of the assets that the distributee is deemed to have surrendered.

3. Hypothetical sale of surrendered assets by distributee to partnership.

4. Distribution of the remaining assets received by the distributee.
Hot Assets-IRC Section 751(b)

- John, Paul, and Ringo are equal partners in Obladi Partnership.

- John wants to retire, and there are some hot assets on the books.

- Here’s what the balance sheet looks like…
### Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$12,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Inventory – Vinyl Records</td>
<td>$1,500</td>
<td>$6,000</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td><strong>$13,500</strong></td>
<td><strong>$18,000</strong></td>
</tr>
<tr>
<td>John</td>
<td>$4,500</td>
<td>$6,000</td>
</tr>
<tr>
<td>Paul</td>
<td>$4,500</td>
<td>$6,000</td>
</tr>
<tr>
<td>Ringo</td>
<td>$4,500</td>
<td>$6,000</td>
</tr>
<tr>
<td><strong>TOTAL EQUITY</strong></td>
<td><strong>$13,500</strong></td>
<td><strong>$18,000</strong></td>
</tr>
</tbody>
</table>

Inventory has substantially appreciated (value exceeds 120% of basis)
It is agreed that John is to receive $6,000 in value of partnership assets for retiring.

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>FMV, John’s Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$12,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Inventory – Vinyl Records</td>
<td>$6,000</td>
<td>$2,000</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td><strong>$18,000</strong></td>
<td><strong>$6,000</strong></td>
</tr>
</tbody>
</table>

Three distribution scenarios:
1. Actual share in both classes
2. More than his share of hot assets and less of his share of non-hot assets
3. Less than his share of hot assets and more than his share of non-hot assets
Hot Assets-IRC Section 751(b)

- Under Scenario 3:
  - Distribution of $6,000 cash
  - Less than proportionate share of hot assets means that Sec. 751(b) applies.
  - John is considered to have sold his share of the relinquished hot assets for the consideration actually received.
  - Remaining partners considered to have purchased John’s share of hot assets relinquished in return for the property actually distributed.
Hot Assets-IRC Section 751(b) (continued)

- Under the Regulations, John is treated as having received
  - $4,000 (one-third interest in partnership’s cash)
  - $2,000 FMV of vinyl records (adj basis of $500)
- He is treated as having sold the interest in the hot assets to the partnership in return for the $2,000 in cash which he actually received.

<table>
<thead>
<tr>
<th>Amount Realized (cash)</th>
<th>$2,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/B of hot assets</td>
<td>$500</td>
</tr>
<tr>
<td>Gain taxed as Ordinary Inc.</td>
<td>$1,500</td>
</tr>
</tbody>
</table>

- Obladi has no gain or loss to report.
  - Deemed to have used $2,000 of cash to purchase John’s interest in hot assets.
- Obladi now has additional $2,000 of basis to add to $1,000 basis of inventory not involved in Sec. 751(b) deemed distribution.
Hot Assets-IRC Section 751(b) (continued)

- Under Scenario 2:
  - Distribution of $6,000 inventory
  - Excess distribution of hot assets means that Sec. 751(b) applies.
  - John is considered to have traded his share of the relinquished non-hot assets for the consideration actually received.
  - Remaining partners considered to have purchased John’s share of non-hot assets relinquished in return for the property actually distributed.
Hot Assets-IRC Section 751(b) (continued)

- Under the Regulations, John treated as having received
  - $4,000 (one-third interest in partnership’s cash)
- And with this cash, deemed to have purchased
  - Two-thirds interest in the inventory
- The other $2,000 of distributed inventory represents John’s share of hot assets before distribution.

<table>
<thead>
<tr>
<th>Basis in “Distributed” Inventory</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>John’s original basis in LLC interest</td>
<td>$4,500</td>
</tr>
<tr>
<td>Reduced by deemed cash distribution</td>
<td>$4,000</td>
</tr>
<tr>
<td>Basis in Distributed Inventory</td>
<td>$  500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Basis in Inventory</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis in “Purchased” Inventory</td>
<td>$4,000</td>
</tr>
<tr>
<td>Basis in “Distributed” Inventory (above)</td>
<td>$500</td>
</tr>
<tr>
<td>Basis</td>
<td>$  4,500</td>
</tr>
</tbody>
</table>
Consequence to LLC

- Obladi is treated as selling 2/3 of it’s inventory to John for $4,000.
- Obladi will recognize ordinary income of $3,000. (FMV of $4,000 less basis of $1,000)
- This gain will be allocated to Paul and Ringo.
Hot Assets – IRC Section 751(b)

Sec. 751 Challenges

- Ordinary income or loss is realized on sale or exchange of partner’s interest in Sec. 751 property.

- Ordinary income under Sec. 751 may count as self-employment income.

- Collapsible partnership provisions can create ordinary income and capital loss from what would otherwise have been a net capital gain.
Hot Assets – IRC Section 751(b)

Reporting Requirements

- Distributee Partner
  - Pursuant to Reg. Sec. 1.751-1(a)(3), file statement with individual tax return for year in which transfer occurs, showing:
    - Transfer Date,
    - Gain/Loss attributable to Sec. 751 property, and
    - Gain/Loss attributable to capital gain or loss on sale of partnership interest.

- Partnership
  - Form 8308 not required to be filed if distribution is treated as sale or exchange under Sec. 751(b). [Reg. 1.6050K-1(a)(4)(i)]
  - However, statement similar to above is required under Reg. Sec. 1.751-1(b)(5).
Basis Adjustments
Distributions of Partnership Property

- **Sec. 734(a)**
  - Generally, the adjusted basis of partnership property does not change when the partnership distributes property to a partner in a distribution – the partner would receive the same basis in the property that the partnership held, assuming his adjusted basis in his partnership interests exceeded the basis of the property immediately before the distribution.

- If a distributee partner recognizes gain or loss because of a distribution of partnership property, the partner’s adjusted basis in the property will increase or decrease appropriately. The increase/decrease can cause subsequent distortions in the amount and timing of income.
Section 734(b) Adjustment: Common Basis Adjustment

- **Increase inside basis of partnership property by**
  - Amount of gain recognized by distributee partner with respect to distribution
  - Excess of inside basis of property distributed over basis of property to distributee partner

- **Decrease inside basis of partnership property by**
  - Amount of loss recognized by distributee partner with respect to distribution
  - Excess of distributee partner's basis for distributed property over inside basis of property to partnership immediately before distribution
Section 755 Allocation Rules: Section 734(b) Adjustment

- First, apply general rule of Sec. 755(b) and divide partnership assets into two classes:
  - (1) capital and Sec. 1231(b) assets, and
  - (2) all other assets
Section 755 Allocation Rules: Section 734(b) Adjustment

- If distributee partner recognizes a gain or a loss because of the distribution, the Sec. 734(b) adjustment is allocated to the capital and Sec. 1231(b) class of assets.

- If distributee partner takes distributed asset with a basis different from partnership’s basis, amount of difference is allocated to same class of assets as substituted basis property.
Mandatory Basis Adjustments

- When there is a “substantial basis reduction” or a “substantial built-in loss,”

- Sec. 734(d) and Sec. 743(d) require basis adjustments
  - A substantial basis adjustment for purposes of Sec. 734(d) is a downward adjustment of more than $250,000.
  - A substantial built-in loss for purposes of Sec. 743(d) exists when the partnership’s basis in the assets exceeds the assets’ fair market value by more than $250,000.
  - Rules under Sec. 734(d) and Sec. 743(d) do not apply to securitization partnerships.
  - Sec. 743(d) basis adjustments to partnership assets do not apply to certain electing investment partnerships.
Section 734(b) Example

**John, Paul and George form an LLC**

John contributes $500,000 and Paul and George each contribute $250,000

The LLC buys 3 stocks:

1) A Corp- $200,000
2) BigCo Corp- $400,000
3) Deal Corp- $400,000

The investments did not fare well. A’s FMV fell to $100,000. BigCo’s FMV fell to $75,000 and Deal’s FMV fell to $25,000. John said enough and in liquidation of his 50% interest received the A stock.
Because the $300,000 increase in basis of the A stock exceeds $250,000 due to the distribution of it to John, the LLC must decrease its basis in BIGCO and DEAL prorata by $300,000-the amount of the basis increase in the A stock.

Negative Sec. 734(b) adjustment of $300,000 allocated to undistributed assets under Sec. 755 even if no Sec. 754 election in effect.
Pitfalls

I think I've reached the 'point of no return'!
Just when you thought you had capital gain………..

- If Sec. 751 assets are present, a distribution of cash in liquidation of a partnership interest can result in the distributee partner recognizing ordinary income attributable to “hot assets” instead of capital gain, or even ordinary income greater than the net gain with an offsetting capital loss.

- EXAMPLE: John is a 50% owner of the Yellow Submarine Partnership. Yellow Submarine holds two assets: a submarine with a basis of zero and a value of $200,000. It also holds cash of $200,000. John’s basis in Yellow Submarine is $100,000. John receives a liquidating distribution of $200,000. What are his tax consequences?

  However…
Just when you thought you had capital gain….

- John thinks he has a $100,000 capital gain.
- However, due to Sec. 751, John is treated as selling his 50% interest in a “hot asset” for $100,000 resulting in $100,000 of ordinary income.
- The remaining $100,000 is applied against his tax basis capital account of $100,000 resulting in no further gain or loss.
- Note: total income reported by John is $100,000, but his tax bill is significantly different.
Outside Basis of Interest becomes Basis of asset received

Lucy is a 25% partner in Sky Partnership. Her outside tax basis is $1,000,000, and her 25% interest in the partnership is valued at $100,000.

She is distributed a diamond in liquidation of her partnership interest. The diamond’s basis inside the partnership is $75,000, and it’s FMV is $100,000.

Lucy recognizes no gain or loss on the property distribution in liquidation of her partnership interest, and takes basis in the diamond of $1,000,000. Lucy doesn’t want to part with the diamond, but she won’t be able to recognize the $900,000 loss until she sells it.
Distribution of inventory (5 year taint)– Reg. Sec. 1.735-1(a)(2)

- The gain or loss on the disposition of property which was inventory to the partnership is ordinary if the inventory is disposed of within 5 years of the distribution. If the disposition takes place 5 years after the date of the distribution, then the character of the gain or loss depends on the inventory's character in the hands of the distributee partner at the date of sale (that is, inventory, capital asset, trade or business asset).

- If an inventory item appreciates in the distributee partner's hands, the post-distribution appreciation will also be subject to the 5-year ordinary income taint period.
Final Observations

- Negative adjustments cannot reduce an asset’s basis to less than zero. If this limit prevents full allocation of a negative adjustment, the excess becomes a carryover and is applied to property the partnership acquires in the future. See Prop. Regs 1.755-1(c)(2)-(4).

- Sections 734 and 743 operate differently. Sec. 734 operates for the benefit of all partners. Sec. 743 operates for the benefit of the transferee partner only.

- Sec. 743 regulations provide for increasing the basis of some assets and decreasing the basis of others. Sec. 734 regulations provide for only an increase or a decrease.
Final Observations

- The adjustments are calculated differently for Sec. 734 and Sec. 743

- Sec. 734(b) makes the adjustment equal to the distributee’s gain or loss. Sec. 743(b) makes the calculation by comparing the buyer’s basis to the buyer’s share of inside basis.
It has all “Come Together”

- Sec. 751(b) applies to both current & liquidating distributions.

- Sec. 751(b) applies only when a disproportionate distribution of hot and non-hot assets is made to a partner.

- Recognition of gain or loss on distributions of property results in basis adjustments for partner and partnership.

- Sec. 751(b) Pitfalls
  - Conversion of capital gain to ordinary income
  - Outside basis of interest becomes basis of asset received
  - Five year taint on distribution of inventory
Distributions

General Rule: if property is distributed to a partner, he recognizes no gain, except to the extent that any money he receives exceeds the adjusted basis of his partnership interest immediately before the distribution. §731(a)(1).
Exceptions

• §751(b) – disproportionate distributions.
• §731(c) - Marketable securities treated as money.
• §§704(c)(1)(b) and 737 – the mixing bowl rules.
• §707 – Disguised sales.
§704(c)(1)(B)

If a partner contributes property to a partnership, and within 7 years of the contribution, the partnership distributes the property to another partner, then the contributing partner recognizes gain or loss under §704(c)(1)(A) in the same amount as if the partnership had sold the property for its fair market value at the time of the distribution. §704(c)(1)(B).
§704(c)(1)(A): Special Allocation of Gain or Loss

General Rule: if a partner contributes appreciated property to a partnership (meaning the property’s FMV exceeds its AB), then upon the sale of the property by the partnership, the contributing partner is specially allocated gain up to the amount of the excess of the property’s book value over its adjusted basis at the time of sale. §704(c)(1)(A) and the Regulations thereunder.
Three methods of allocation

- Under the Regulations, there are three ways special allocations can be made under §704(c)(1)(A): the so-called “traditional method,” the “traditional method with curative allocations,” and the “remedial method.”
- The traditional method requires that if the partnership sells “section 704(c) property,” the built-in gain or built-in loss must be specially allocated to the contributing partner. However, the gain cannot exceed the gain recognized by the partnership on the sale of the property.
Special Allocations under §704(c)

• Not only does §704(c) require a special allocation of gain or loss, but of depreciation as well. This is important for determining “book value.”

• Using the “traditional method,” book depreciation is first allocated among the partners in accordance with their profit or loss sharing ratios, and the non-contributing partners are entitled to tax depreciation equal to their shares of book depreciation. The contributing partner is entitled to the balance of the tax depreciation, if any.
Example 1

• A, B, and C form the equal partnership ABC. A contributes depreciable property having a FMV of $30,000 and an AB of $20,000. B and C each contributes cash of $30,000. The property has a depreciable life of 10 years.

• As a result, ABC has book depreciation of $3,000 per year, and tax depreciation of $2,000 per year.
Example 1, continued

• A, B, and C each are allocated $1,000 of book depreciation. Tax depreciation is allocated $1,000 to each of B and C to match their shares of book depreciation. A is not entitled to any tax depreciation because of the so-called “ceiling rule,” which provides that a partner cannot be allocated more tax depreciation than there is total tax depreciation available.
Example 1, continued

In this example, the beginning book value of the property is $30,000, and its AB = $20,000. At the end of the year, the book value will be $27,000 ($30,000 - $3,000 book depreciation), and the AB = $18,000 ($20,000 - $2,000 tax depreciation). The difference between tax and book values is therefore $9,000, and this is the amount of the built-in gain that must be allocated to A if the property is sold for at least $27,000.
Definitions

• §704(c) property: property contributed by a partner whose book value (ie, FMV at the time of contribution) exceeds the contributing partner’s AB in the property. (Also applies to revaluations – “reverse §704(c) allocations” - Reg. §1.704-3(a)(6).)

• Built-in gain: the excess of the property’s book value over the contributing partner’s AB at the time of contribution.

• Built-in loss: the excess of the contributing partner’s AB over the property’s book value at the time of contribution.
Example 2

• A contributes raw land to the ABC equal partnership. The land, a capital asset in the hands of the PS, has an AB = $400 and a FMV = $1,000. B and C each contribute cash of $1,000. In the hands of the PS, the property’s book value = $1,000, and its AB = $400. The PS sells the property for $1,300. The partnership uses the “traditional method.”

• Built-in gain = $600 ($1,000 – 400).
Example 2, continued

There will be a “book gain” of $300 ($1,300 amount realized less $1,000 book value), allocated one-third ($100) to each partner. The taxable gain = $900 ($1,300 - $400 AB). This gain is allocated as follows:

1. the first $300 (equal to the book gain) is allocated $100 to each partner;

2. the balance of $600 must be specially allocated to A, the contributing partner. A’s AB for his PS interest will increase by $600.
Example 2, continued

Assume that instead of selling the land the partnership distributes the land to B in a current distribution within 7 years after A contributed it to the partnership. Under the mixing bowl rules, A would recognize a capital gain of $600, the amount of the built-in gain on the property he would be allocated under §704(c)(1)(B) if the PS sold the property. The character of the gain is the same as if the partnership sold the land for its FMV.
Example 2, continued

• In addition to recognizing $600 gain, A will increase the adjusted basis of his partnership interest by the amount of the gain recognized. Reg. §1.704-4(e)(1).

• The partnership will increase, immediately before the distribution, the adjusted basis of the land by the $600 of gain recognized by A. Reg. §1.704-4(e)(2). Thus, B will obtain an AB = $1,000 in the land ($400 initial AB + $600 A’s recognized gain).
Example 3

- A contributes raw land to the ABC partnership. The land has a FMV = $500 and an AB = $1000. B and C each contribute cash of $500. There is a built-in loss of $500. The partnership sells the property for $500, realizing a loss of $500. The entire $500 tax loss must be specially allocated to A under the traditional method.
Exception to §704(c)(1)(B)

Like-Kind exchange. If §704(c) property is distributed to a partner other than the contributing partner and like-kind property (within the meaning of §1031) is distributed to the contributing partner no later than the earlier of:

(i) 180 days following the date of the distribution to the non-contributing partner, or

(ii) the due date (with regard to extensions) of the contributing partner’s tax return for the taxable year of the distribution to the non-contributing partner, then
Like-Kind Exchange Exception

the Gain or Loss, if any, that the contributing partner would otherwise have recognized under §704(c)(1)(B) is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution.
Transfer of Partnership Interest

The transferee of a contributing partner’s partnership interest is considered to be the contributing partner for purposes of §704(c)(1)(B). Thus, a transferee steps into the shoes of the transferor contributing partner. Reg. §1.704-4(d)(2).
Section 737

This section applies when a partner contributes appreciated property to a partnership, and within 7 years of the contribution, the partnership distributes property (other than money) to the contributing partner. In this situation, unless an exception applies, the contributing partner recognizes gain.
§737

§737: if a partnership distributes property to a partner, he must recognize gain equal to the lesser of:

1. The excess (if any) of (A) the FMV of the property (other than money) received over (B) the distributee partner’s AB for his partnership interest immediately before the distribution, reduced by any money received in the distribution; or

2. The distributee partner’s “pre-contribution gain.”
Pre-contribution Gain

Subject to some exceptions, the distributee partner’s net precontribution gain is the net gain, if any, that would have been recognized by the distributee partner under §704(c)(1)(B) if all property that had been contributed to the partnership by the distributee partner within 7 years of the distribution and is held by the partnership immediately before the distribution had been distributed to another partner other than a partner owning, directly or indirectly, more than 50% of the capital or profits interest in the partnership.
Example 4

• On January 1, 2005, A, B, and C form equal partnership ABC. A contributes depreciable real estate having an AB of $20,000 and a FMV of $30,000. B contributes non-depreciable real estate having a FMV and AB of $30,000. C contributes cash of $30,000. Note there is a total of $10,000 of appreciation in value.

• The depreciable property has 10 years of useful life remaining, and the PS uses the traditional method. Annual book depreciation = $3,000, and annual tax depreciation = $2,000.
Example 4, continued

• The $3,000 book depreciation is allocated $1,000 to each partner, and the tax depreciation is allocated $1,000 each to B and C, and none to A. At the end of 2007, the property has a book value of $21,000 and an adjusted basis of $14,000.

• On December 31, 2007, Property B, having a FMV of $30,000, is distributed to A in complete liquidation of his interest. The AB for his PS interest = $20,000 (A was not allocated any PS loss or depreciation – his basis stays the same).
Example 4, continued

• §737 applies to this situation because A received a non-cash distribution within 7 years after A contributed appreciated property.

• The excess distribution = $10,000, the difference between the FMV of the property distributed ($30,000) and A’s AB at the time ($20,000). The net precontribution gain = $7,000, the difference between Property A’s book value ($21,000) and its adjusted tax basis of $14,000. A recognizes gain of $7,000. Reg. §1.737-1(e), Example 1.
Basis Adjustment: Distributee Partner’s AB for his Interest

The distributee partner’s adjusted basis for his PS interest is increased by the amount of gain he recognizes under §737, but the basis increase is not taken into account in determining the gain recognized under §737(a)(1) or the amount of gain recognized under §731 if money is distributed in the same transaction. Reg. §1.737-3(a). Thus, A’s AB is increased by $7,000 to $27,000.
Basis Adjustment: Used in Calculating the AB of Property Distributed

The distributee partner’s adjusted basis in the distributed property is determined under §§732(a) or (b), as appropriate, and the distributee partner’s AB for his PS interest includes any increase because of his gain under §737, except for property previously contributed by the distributee partner.
Basis Increase

In Example 4, A’s AB in his PS interest is increased to $27,000, and Property B has an AB = $27,000 in A’s hands under §732(b) (basis of property received by a partner in complete liquidation of his interest).
Basis Adjustment: Other PS Property

• In addition to the basis increase of A’s interest and the property distributed to A, the AB of “eligible” PS property is increased by the amount of gain recognized.
Eligible Property

- Property that:
  - Entered into the calculation of the distributee partner’s precontribution gain;
  - Has an AB less than its FMV at the time of distribution;
  - Would have the same character of gain on sale by the PS to an unrelated party as the character of gain recognized by the distributee partner on the distribution; and
  - Was not distributed to another partner in a distribution subject to §704(c)(1)(B) that was part of the same distribution as the distribution under §737.
Example 4, continued

• In Example 4, Property A is eligible property. Why?

(1) It entered into the determination of A’s pre-contribution gain.

(2) It had an AB less than FMV at the time of contribution.

(3) It has the same character of gain (capital) on the sale of the property as it would have upon the distribution to A.
Example 4, continued

(4) It was not distributed to another partner in a distribution to which §704(c)(1)(B) applied that was a part of the same transaction as the one occurring under §737.
Example 4, continued

- As a result, the adjusted basis of Property A is increased by the $7,000 of gain recognized by A when Property B is distributed to him.

- Does this make sense? After the PS was formed, the total inherent gain in all the properties contributed was $10,000. If A later sells Property B for its $30,000 FMV, he will recognize a gain of $3,000. When added to the $7,000 previously recognized by A under §737, the total gain recognized by him will be $10,000.
Because Property A is eligible property, the Partnership increases the basis of Property A from $14,000 to $21,000. If that Property is sold for its FMV of $30,000, then there will be a gain of $9,000, which is equal to the book depreciation previously taken. However, only $6,000 of tax depreciation was taken. Thus, the total gain would be $19,000 ($10,000 recognized by A and $9,000 recognized by the partnership).
Example 4, continued

Thus, although there was only $10,000 of inherent gain and tax depreciation “recapture” gain (meaning gain equal to tax depreciation deductions) of $6,000, there will be a total gain of $19,000. There should be only $16,000 of total gain, but instead there is $19,000 of total gain (or potential gain if all the property is sold by A and the PS).
Solution: Section 754 election

The partnership may make a section 734(b)/754 special basis adjustment after taking account of all adjustments under §737. Under §754, the PS may increase the AB of its remaining property of the same class as the property distributed (either capital gain or ordinary income property), equal to the excess of the AB of Property B in the hands of the PS immediately before the distribution to A ($30,000), over the adjusted basis of Property B in the hands of A ($27,000). Thus, the AB of Property A may be increased by $3,000.
Major Exceptions

• §737 does not apply to the following situations (see, Reg. §1.737-2):
  – §708(b)(1)(B) terminations;
  – Transfers to second partnership of all the assets and liabilities, followed by the liquidation of the first partnership;
  – Incorporation of a partnership;
  – Distribution of property previously contributed by the distributee partner.
Impact of §731(c)

• Subject to certain exceptions and limitations, §731(c) provides that a marketable security owned by a partnership is treated as cash, so that if the marketable security is distributed to a partner, and at the time the FMV of the security exceeds the distributee partner’s adjusted basis for his PS interest, he will recognize gain.
• In some situations, it will be possible for sections 704(c)(1)(B) and 737 apply to the same transaction, and it may be possible for §731(c) to also apply if marketable securities are distributed in the same transaction. For example, this could apply in certain family limited partnerships.
Order of Application

• If §731(c) applies to a distribution, and either or both of §704(c)(1)(B) and §737 applies, then §704(c)(1)(B) is applied first, then §731(c), and finally, §737. Reg. §1.731-2(g)(1).
DISGUISED SALES CONTROVERSIES

David Blair, Crowell & Moring
Introduction

• But in this world nothing can be said to be certain, except death and taxes.
  
  (Benjamin Franklin 1789)
What is a Disguised Sale?

• General Rule – Partner contributions and distributions fall under Sections 721 and 731

• Exception – Partnership transactions with partner acting in non-partner capacity:
  – Generally treated as occurring between the partnership and one who is not a partner. Section 707(a)
What is a Disguised Sale?

• Section 707(a)(2)(B) – If,
  i. There is a direct or indirect transfer of money or other property by a partner to a partnership,
  ii. There is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
  iii. The transfers, when viewed together, are properly characterized as a sale or exchange of property,

The transfer shall be treated as a sale between the partner and the partnership, or as a sale between two partners.
What is a Disguised Sale?

- Partner A contributes property
- Partner B contributes cash
- Partnership Distributes cash to A, and property to B
Historical Perspective

- Prior law, Section 707(a) and Treas. Reg. § 1.731-1(c)(3), led to inconsistent results in 1980s:
  - Pro-IRS decisions:
    - *Crenshaw*, (5th Cir. 1971) (purported liquidation treated as sale of partnership interest)
    - *Barenholtz*, (TC 1981) (taxpayer who structured transaction as sale of partial interests in property followed by transfers of property to partnership was stuck with his form)
    - *Jacobson*, (TC 1991) (Contribution of property by partner A and cash by partner B, followed by cash distribution to partner A treated as partial sale of property from A to B followed by partnership formation)
    - *Collonade*, (TC 1988) (admission of new partners, reducing existing partner’s interest and assuming portion of existing partner’s obligations to contribute capital, treated as a sale of partnership interests)
Historical Perspective

- Prior law, Section 707(a) and Treas. Reg. § 1.731-1(c)(3), led to inconsistent results:
  - Pro-taxpayer decisions:
    - Otey, (TC 1978) (no disguised sale of property where partnership borrowed against property and made distribution to contributing partner, who was jointly liable for debt)
    - Communications Satellite Corp. (Ct. Cl. 1980) (no disguised sale on distributions to old partners of amounts contributed by new partners)
    - Park Realty Co., (TC 1981) (contribution of partially completed shopping center followed by reimbursement of pre-formation expenses was non-taxable)
    - Jupiter Corp. (Cl. Ct. 1983) (no disguised sale of partnership interest; 20 percent GP interest not equivalent to 20 percent LP interest; §1.731-1(c)(3) requires intent to effect exchange)
Historical Perspective

• Congress intervenes in 1984
  – Enacts § 707(a)(2)(B), codifying disguised sale rule
  – Legislative history states that *Otey*, *Communications Satellite*, and *Jupiter* applied §§ 721 and 731 “in cases which are economically distinguishable from a sale”

• 1992: Treasury issues regulations on disguised sales of property

• 2004: Treasury proposes and then, in 2009, withdraws regulations on disguised sales of partnership interests
Treas. Reg. § 1.707-3

- Disguised sales of property
- General rule: (i) transfer of property to partnership, and (ii) transfer of consideration to partner (including taking subject to debt), may be treated as a sale of property to the partnership, if
  - No partnership transfer of consideration “but for” partner’s transfer of property; and
  - Where transfers non-simultaneous, later transfer not dependent on “entrepreneurial risks of partnership operations.”
Treas. Reg. § 1.707-3

• Disguised sales of property
  – Simultaneous transfers likely to be deemed sales under “but for” test.
  – Presumption of sale (no sale) for transfers within (outside) two years. Rebuttal of presumption(s) possible based on facts and circumstances.
  – Ten specified factors, including likelihood that subsequent transfer will occur, shifting of benefits and burdens, proportionality of subsequent transfer, and likelihood of repayment.
Year 1:
- B contributes fully leased building to Partnership: FMV = $50 M, Basis = $20 M
- $S_1$ and $S_2$ contribute U.S. Gov’t securities: FMV/Basis = $50 M

Allocations:
- Building items allocated 10% to B, 45% to $S_1$, 45% to $S_2$
- Securities items allocated 90% to B, 5% to $S_1$, 5% to $S_2$

Year 3:
- B’s partnership interest liquidates, and B receives Gov’t securities plus cash

Analysis/Holding:
- Presumption of non-sale (outside 2 year window)
- But, facts clearly establish sale:
  - Low risk assets
  - Allocations shift benefits/burdens of ownership

Mixing Bowl Example: Treas. Reg. § 1.707-3(f) Example 8
Treas. Reg. § 1.707-3

• Operating rules:
  – Transfers can be disguised sale in part
  – Disguised sale is sale for all purposes of IRC
  – Disguised sale occurs upon transfer to partnership
  – Disguised sale rules apply despite sham partnership
  – Transfer pursuant to deemed terminations (§708(b)) disregarded
  – Disclosure obligation for transfers within two years. See also Treas. Reg. § 1.707-8 (additional disclosure rules)
Treas. Reg. § 1.707-4

• Partnership distributions not part of a disguised sale:
  – Guaranteed payments for capital, if reasonable
  – Preferred return, if reasonable
  – Operating cash flow distributions
  – Pre-formation capital expenditures
Debt-financed disguised sale

- Partner A contributes property
- Partnership borrows, distributes proceeds to A
- Partner A does not bear economic risk of loss for partnership’s liability
Treas. Reg. § 1.707-5

- Debt-financed disguised sales, in general:
  - Pre-contribution liability – Partnership assumes, or takes property subject to, debt, and amount assumed exceeds partner’s share of liability immediately following the contribution
  - Post-contribution liability – Partnership borrows against property and distributes proceeds to contributing partner in an amount exceeding partner’s share of liability
- Partner’s share of liability determined under Section 752 regulations
- Special rules apply where transaction otherwise treated as part of a sale
Treas. Reg. § 1.707-5

• Exception for “qualified liabilities”
  – Liability encumbering property over two years prior to contribution transaction
  – Liability encumbering property under two years, but clearly establish not incurred in anticipation of contribution
  – Liability allocable to capital expenditures on contributed property
  – Ordinary trade or business liabilities where all assets of trade or business are contributed to partnership
  – Also must be less than net FMV of contributed property
Treas. Reg. § 1.707-5

• Exception for certain post-contribution liability
  – Partner transfer property to partnership
  – Partnership incurs liability
  – Proceeds transferred to partner within 90 days
  – Partner’s allocable share of debt exceeds proceeds received

• Okay to borrow through the partnership.
  Compare Otey.
Treas. Reg. § 1.707-6

- Disguised sales of property by partnership to partner
  - Apply rules similar to § 1.707-3 and § 1.707-5
  - Expanded definition of “qualified liability” to include debts over two years old regardless of whether they encumbered partnership property during that period
Applications of Disguised Sale Rules to Highly Structured Partnership Transactions

"Now let's talk about that loophole you've claimed!"
Recent Cases on Disguised Sales

- **G-I Holdings**, (D. NJ 2009) (contribution of property followed by non-recourse borrowing against partnership interests is disguised sale; first application of § 707(a)(2)(B))
- **Canal Corp.**, (TC 2010) (disguised sale on partner’s receipt of funds from post-contribution borrowing that was not allocated to partner due to anti-abuse rule of § 1.752-2(j))
- **Va. Historic Tax Credit Fund**, (4th Cir. 2011) (cash contributions followed by state tax credit allocations were disguised sales under regulations’ two-year presumption and ten factor analysis).
- **Historic Boardwalk Hall**, (3d Cir. 2012) (court analogizes sham partner and disguised sale analyses because both look to whether partner’s return depends on entrepreneurial risks of partnership operations)
Are IRS and Courts Expanding Application of the Disguised Sale Rules?

• *Southgate Master Fund*, (5th Cir. 2011) (court applies sham partnership analysis to find sale and step down basis in loss property contributed to partnership)

• *Rovakat*, (TC Memo 2011) (court cites disguised sale rules as alternative ground for step down of basis in contributed assets)

• *Superior Trading*, (7th Cir. 2013) (same)