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Tax Implications of Transactions Between Partners: IRC 704(c)(1)(B), 707, 737, and 751(b)

Navigating the Complex Disguised Sales Rules

THURSDAY, DECMEBER 12, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Review of Tax Consequences of Disguised Sales

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Tax Consequences of Contributions of Property Without Disguised Sales

Nonrecognition of Gain or Loss

The contribution of property to a partnership is a nontaxable event. § 721(a) provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Basis

- Under § 722 of the Code, a contributing partner's basis in a partnership is equal to any cash contributed plus the contributor's adjusted basis (determined at the moment of contribution) of any other property contributed. Under § 723, the partnership generally takes as its basis in the contributed property the contributing partner's adjusted basis in the contributed property.

Character of Contributed Property

- The partnership's purpose for holding property generally determines the character of a gain or loss realized by a partnership upon its sale, and the purpose for which an asset was held before its contribution is not considered. The owner will also want to take ordinary losses as opposed to capital losses from business operations or the failure of the business.

  - Exception: § 724: Anti-Conversion Rules. § 724 carves out three classes of contributed assets that are subject to special characterization rules: (1) unrealized receivables; ordinary; (2) income inventory items; ordinary income if sold within 5 years; and (3) capital assets that have declined in value; remains capital loss property for 5 years.

Taxation of Distributions Not Involving Disguised Sales

Current Distributions

- A "Current Distribution" is a distribution other than in complete termination of a partner's interest in the partnership.
  - Recognition of Gain. In the case of a current distribution, gain is recognized only to the extent the amount of money received exceeds partner's adjusted basis in his partnership interest.
  - Recognition of Loss to Partner. No loss is recognized as a result of a current distribution (IRC §731(a)(2)).
  - Taxation to Partnership. Although there are several exceptions, the general rule is that, there is no recognition of gain or loss to the partnership on a distribution of property (IRC §731(b)).

Liquidating Distributions

- A liquidating distribution is one in which a partner's interest in the partnership is completely retired.

  - Recognition of Gain to Partner. Same as current distributions.

  - Recognition of Loss to Partner. Loss is recognized if and only if a partner receives, in complete termination of his interest, only cash, unrealized receivables, and inventory.

  - Taxation to Partnership. Although there are several exceptions, the general rule is that there is no gain or loss to partnership as the result of a liquidating distribution.

Example #1: Taxation of Liquidating Distributions

- A receives, in termination of his partnership interest from ABC partnership, one-third of partnership assets, net of liabilities.

Type	Basis	Value
Assets		
Cash	$12,000	$12,000
Inventory	$15,000	$15,000
Liabilities		
Accounts Payable	$9,000	$9,000
Capital		
A - $6,000 B - $6,000 C - $6,000		

- Assume A has a basis of $7,000 in his partnership interest. He receives $1,000 cash, $5,000 of inventory and he is relieved of $3,000 of debt. His basis in the inventory would be $3,000 and no gain or loss would be recognized. ($7,000 - $1,000 - $3,000 = $3,000.)

- If A had a basis of $11,000 in the partnership he would be treated as receiving $4,000 cash [$1,000 actually received plus $3,000 constructively received under §752(b)]. His basis in the inventory would be $5,000 and he would have a loss of $2,000.

Basis of Property Received by Partner in Current or Liquidating Distribution

- Generally speaking, the partnership's inside basis carries over to the partner on a distribution in kind but a partner's collective basis in the assets received cannot exceed his adjusted basis in his partnership interest.

Shifts in Debt: Basic Tax Concepts: Treatment as Cash Received or Contributed

Partner's Share of Recourse Debt

- The Regulations define a partnership liability as "recourse" to the extent that any partner or related person bears the economic risk of loss for the liability.

- **A PARTNER BEARS THE ECONOMIC RISK OF LOSS FOR A PARTNERSHIP LIABILITY TO THE EXTENT THAT, IF THE PARTNERSHIP CONSTRUCTIVELY LIQUIDATED, THE PARTNER OR RELATED PERSON WOULD BE OBLIGATED TO MAKE A PAYMENT TO ANY PERSON (OR A CONTRIBUTION TO THE PARTNERSHIP) DUE TO THE FACT THAT THE LIABILITY BECOMES DUE AND PAYABLE AND THE PARTNER OR RELATED PERSON WOULD NOT BE ENTITLED TO REIMBURSEMENT FROM ANOTHER PARTNER OR A PERSON RELATED TO ANOTHER PARTNER.**

Constructive Liquidation

- The following circumstances constitute a constructive liquidation for purposes of the § 752 regulations:
  - All of the partnership's liabilities become payable in full;
  - With the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero;
  - The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);
  - All items of income, gain, loss or deduction are allocated among the partners; and
  - The partnership liquidates.

Example #2: Determining When a Partner Bears the Economic Risk of Loss for Recourse Debt

- A and B form a general partnership with each contributing $100 in cash. The partnership purchases an office building on leased land for $1,000 from an unrelated seller, paying $200 in cash and executing a note to the seller for the balance of $800. The note is a general obligation of the partnership, i.e., no partner has been relieved from personal liability. The partnership agreement provides that all items are allocated equally except that losses from depreciation or the sale of real property are specially allocated 90% to A and 10% to B and that capital accounts will be maintained in accordance with the regulations under § 704(b), including a deficit capital account restoration obligation on liquidation. In a constructive liquidation, the $800 liability becomes due and payable. All of the partnership's assets, including the building, are deemed to be worthless.
- The building is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

	A	B
Initial contribution	$100	$100
Loss on hypothetical sale	(900)	(100)
	($800)	$-0-

- Other than the partners' obligation to fund negative capital accounts on liquidation, there are no other contractual or statutory payment obligations existing between the partners, the partnership and the lender. Therefore, $800 of the partnership liability is classified as a recourse liability because one or more partners bear the economic risk of loss for nonpayment. B has no share of the $800 liability since the constructive liquidation produces no payment obligation for B. A's share of the partnership liability is $800 because A would have an obligation in that amount to make a contribution to the partnership

Partner’s Share of Nonrecourse Liabilities

- A partner’s share of partnership nonrecourse liabilities includes the following three tiers:
  - The partner’s share of partnership “minimum gain” determined in accordance with the rules of § 704(b)(Tier-1);
  - The amount of any taxable gain that would be allocated to the partner under § 704(c) if the partnership disposed of all partnership property subject to one or more nonrecourse partnership liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration (§ 704(c) Minimum Gain) (Tier-2); and
  - The partner’s share of excess nonrecourse liabilities (defined as nonrecourse liabilities not allocated under (a) or (b) above) (Tier-3).

Example #3: Determining Allocation of Nonrecourse Debt Under Tier 1

- Partnership AB is a two-person equal partnership composed of A and B. AB buys property by paying $20,000 as a down payment and $80,000 as a nonrecourse note. The entire property is depreciable on a straight-line basis over 10 years with no residual value. In the first and second year, there would be no “minimum gain” since no gain would be realized if the property were disposed of solely in consideration of the relief of the nonrecourse debt of $80,000. On the first day of year four (and ratably during year three), there would be minimum gain, because the basis of the property would be $70,000 and a disposition of the property for the relief of the $80,000 nonrecourse debt would produce $10,000 of “minimum gain.” In tax parlance, there has been an “increase” in “minimum gain” of $10,000 from the beginning year three to the beginning of year four. Similarly, there has been $10,000 of “partnership nonrecourse deductions” for this period and “A” and “B” each have $5,000 of “partner nonrecourse deductions” for this period. Under Tier-1, both A and B would be allocated $5,000 of nonrecourse debt.

Example #4: Determining Allocation of Nonrecourse Debt Under Tier 2

- C and D form an equal partnership CD. C transfers Blackacre with a basis of $50,000 and a value of $100,000. D transfers $100,000 in cash. CD takes out a nonrecourse loan secured by Blackacre in the amount of $80,000. There is a total of $50,000 of built-in gain in the property contributed by C. C's Tier-2 allocation of the nonrecourse loan would be $30,000 ($80,000 - $50,000 = $30,000) because under § 704(c), the $30,000 of § 704(c) built-in gain in Blackacre will be allocated to C when Blackacre is sold solely in satisfaction of the nonrecourse debt of $80,000. Therefore, C's share of § 704(c) minimum gain is $30,000.

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Tier-3

- The Regulations provide three principal alternative methods for determining a partner's share of excess nonrecourse liabilities. Excess nonrecourse liabilities are determined by subtracting the Tier 1 and Tier 2 allocated nonrecourse liabilities from the total nonrecourse liability. A partnership need not allocate excess nonrecourse liabilities under the same method each year.

Netting of Increases and Decreases of Liabilities Resulting from Same Transaction

- Regulations § 1.752-1(f) allows a partner to net out increases and decreases in liabilities which result from the same transaction. Therefore, if, as a result of a single transaction, a partner's share of individual or partnership liabilities increases and decreases, only the net increase is treated as a contribution of money to the partnership and only the net decrease is treated as a distribution of money from the partnership.

Example #5: Netting Debt on Contribution of Property

- A and B form a partnership. A contributes land with a basis of $5,000 and a gross value of $20,000. The land is encumbered by a nonrecourse debt of $10,000. B contributes $10,000 in cash. Under § 704(c) the built in gain in the land is $15,000 and is allocable to A. Under Tier 2, the § 704(c) minimum gain is $5,000. Therefore, A would be allocated $5,000 of the nonrecourse debt as a Tier 2 allocation. The remaining $5,000 of nonrecourse debt would be allocated 50/50 under Tier 3 so A would be allocated $2,500 and B would be allocated $2,500. A’s basis would be equal to the basis of the land contributed ($5,000) less the nonrecourse liability assumed by the partnership ($10,000) plus A’s share of nonrecourse debt allocated to A ($7,500), for a total of $2,500. B’s basis would be $10,000 plus his share of nonrecourse debt ($2,500) for a total of $12,500.

Disguised Sales Rules (Excluding IRC §751)

- Notwithstanding § 731, not every distribution will be treated as nontaxable. There are four (4) separate disguised sale rules in the Code: §707(a)(2)(B); §737; §704(c)(1)(B) and §751(b).

§ 707(a)(2)(B)

- § 707(a)(2)(B) generally treats a "contribution" of property followed by a "distribution" of other property to the same partner in a related transaction which occurs within two (2) years (or maybe longer) as a disguised sale with gain or loss being recognized.

§ 704(c)(1)(B)

- § 704(c)(1)(B) requires recognition of built-in gain to the contributing partner when a contributing partner contributes property with built-in gain and that same property is distributed to another partner within seven (7) years.

§ 737

- § 737 compliments §704(c)(1)(B) by providing that if a contributing partner contributes property which has built-in gain and the contributing partner receives a distribution of other property within seven (7) years that the built-in gain on the original transfer must be recognized by the contributing partner.

§ 751(b)

- § 751(b) treats a “Disproportionate Distribution” as a disguised sale when the partnership has hot assets.

§ 707(a)(2)(B): Facts and Circumstances Test

- A facts and circumstances test will be applied to determine whether the transaction resembles a sale or exchange of property under § 707(a)(2)(B). In general, contributions of property (excluding money) to a partnership and distribution of money or other consideration (including the assumption of debt or taking property subject to a liability) by the partnership to the partner will constitute a sale if, based on all of the facts and circumstances, (1) the partner's receipt of money or other consideration would not occur but for the transfer of property, and (2) if the transfers are not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

  - The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer.
  - The transferor has a legally enforceable right to the subsequent transfer.

§ 707(a)(2)(B): Facts and Circumstances Test (con't)

- The partner's right to receive the transfer or money or other consideration is secured in any manner, taking into account the period during which it is secured.
- 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.
- Any person has loaned or agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether such lending obligation is subject to contingencies related to the results of partnership operations.
- 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 facts as whether any person has agreed to guarantee or assume personal liability for that debt);

§ 707(a)(2)(B): Facts and Circumstances Test (con't)

- 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);
- Partnership distributions, allocations, or control of partnership operations are designed to effect an exchange of the burdens and benefits of ownership of property;
- 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 the partner either has no obligation to return or repay the money or other consideration to the partnership or has such an obligation but the obligation 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.

Example #6: Treatment of Simultaneous Transfers as a Sale Under §707(a)(2)(B)

- A transfers property X to partnership AB on April 9, 2012, in exchange for an interest in a partnership. At the time of the transfer, property X has a fair market value of $4,000,000 and an adjusted tax basis of $1,200,000. Immediately after the transfer, the partnership transfers $3,000,000 in cash to A. Assume that, under this section, the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Because the amount of cash A receives on April 9, 2012, does not equal the fair market value of the property, A is considered to have sold a portion of property X with a value of $3,000,000 to the partnership in exchange for the cash. Accordingly, A must recognize $2,100,000 of gain ($3,000,000 amount realized less $900,000 adjusted tax basis ($1,200,000 multiplied by $3,000,000/$4,000,000)). Assuming A receives no other transfers that are treated as consideration for the sale of the property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,000,000 of the fair market value of the property with an adjusted tax basis of $300,000.

Exception Under Two-Year Presumption

- Unless the facts and circumstances clearly establish that the transfers do not constitute a sale, if a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner within a two-year period, then the transfers are presumed to be sales of the property to the partnership.

- If the transfer of property by the partner to the partnership and the transfer of money or other consideration to the partner by the partnership take place more than two years apart, then the transfers are presumed to not constitute sales of the property to the partnership, unless the facts and circumstances clearly establish that the transfers constitute sales.

Example #7: Operation of Presumption for Transfers More Than Two Years Apart

- G transfers undeveloped land to the GH partnership in exchange for an interest in the partnership. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of $500,000 and a fair market value of $1,000,000. H contributes $1,000,000 in cash in exchange for an interest in the partnership. Under the partnership agreement, the partnership is obligated to construct a building on the land. The projected construction cost is $5,000,000 which the partnership plans to fund with its $1,000,000 in cash and the proceeds of a construction loan secured by the land and improvements.
- Shortly before G's transfer of the land to the partnership, the partnership secures commitments from lending institutions for construction and permanent financing. To obtain the construction loan, H guarantees completion of the building for a cost of $5,000,000. The permanent loan will be funded upon completion of the building, which is expected to occur two years after G's transfer of the land. The amount of the permanent loan is to equal the lesser of $5,000,000 or 80 percent of the appraised value of the improved property at the time the permanent loan is closed. Under the partnership agreement, the partnership is obligated to apply the proceeds of the permanent loan to retire the construction loan and to hold any excess proceeds for transfer to G 25 months after G's transfer of the land to the partnership.

Example #7: Operation of Presumption for Transfers More Than Two Years Apart (con't)

- G's transfer of the land to the partnership and the partnership's transfer of $1,000,000 to G occurred more than two years apart. Those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale of the property, in whole or in part, to the partnership. In addition, at the time G transferred the land to the partnership, G had a legally enforceable right to receive a transfer from the partnership at a specified time and amount that equals the excess of the permanent loan proceeds over $4,000,000. In this case, however, there was a significant risk that the appraised value of the property would be insufficient to support a permanent loan in excess of $4,000,000 because of the risk that the partnership would not be able to achieve a sufficient occupancy level. Therefore, the facts of this example indicate that at the time G transferred the land to the partnership the subsequent transfer of $1,000,000 to G depended on the entrepreneurial risks of partnership operations. Accordingly, G's transfer of the land to the partnership is not treated as part of a sale.

Exception: Reasonable Guaranteed Payments

- Reasonable guaranteed payments for capital made to a partner are not treated as part of a sale of property. A guaranteed payment for capital is any payment to a partner by a partnership that is determined without regard to the partnership income and that is for the use of that partner's capital. Payments are not treated as being made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership rather than to a provide the partner with a return on an investment in the partnership.

Exception: Reasonable Preferred Returns

- Reasonable preferred returns presumptively do not constitute part of a sale of property to a partnership. A preferred return is a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched by an allocation of income or gain. (Regulations § 1.707-4(a)(2).)

Definition of Reasonable Preferred Returns and Guaranteed Payments

- Preferred returns or guaranteed payments for capital are reasonable only to the extent that the transfer is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.

- A preferred return or guaranteed payment for capital is presumed reasonable in amount if the sum of any preferred return and any guaranteed payment for capital that is payable for that year does not exceed the amount determined by multiplying either the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid preferred return or guaranteed payment for capital that is payable to the partner) by the safe harbor interest rate for that year. The safe harbor interest rate for a partnership's taxable year equals 150 percent of the highest applicable Federal rate. (Regulations §1.707-4(a)(3))

<u>Example #8: Excepting for Reasonable Guaranteed Payments</u>

- In Example (2) of Regulations §1.707-4(a)(4), partner C contributes property with a value of $100,000 and obtains a general interest of 75 percent in partnership profits, losses, and distributions, except that for the first four years of the partnership term, he is also entitled to an annual guaranteed payment of $8,333 (8.333 percent of his capital contribution). This payment is to be made solely out of the other partner's share of partnership distributions; if the other partner's share is insufficient, the other partner is obligated to make capital contributions to fund any shortfalls if the partnership is liquidated. The guaranteed payments satisfy the various requirements in the Regulations, and hence are <u>presumed</u> not to be part of a sale even to the extent paid within two years of the property transfer. However, in this instance, the presumption is rebutted because the facts clearly establish that the payments are part of a sale.
- Specifically, C has effectively sold the other partner a 25 percent interest in the property he contributed to the partnership because four annual payments of $8,333 are approximately equal to the payments that would have been necessary to pay off a $25,000 loan over four years, as if the partnership (or the other partner) had borrowed $25,000 to purchase a 25 percent interest in the property. Further, under the terms of the partnership agreement, the entire economic burden of these payments effectively falls on the other partner. The transaction is treated as if C had sold a one-quarter interest in the property to the partnership. The critical elements of Example (2) appear to be the limited duration of the guaranteed payment and the fact that the other partner is economically bearing the entire payment. Absent these elements, or their equivalent, sale treatment does not appear warranted.

Exception: Operating Cash Flow Distributions

- Certain operating cash flow distributions are presumed to not constitute part of a sale of property to a partnership unless the facts and circumstances clearly establish that the transfer is part of a sale. Operating Cash Flow Distributions are one or more transfers of money by a partnership to a partner during a tax year of the partnership to the extent that the transfers: (1) are not guaranteed payments; (2) are not reasonable preferred returns; (3) are not characterized as distributions to the partner acting in a capacity other than as a partner; and (4) do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of: (i) the partner's percentage interest in overall partnership profits for that year; or (ii) the partner's percentage interest in overall partnership profits for the life of the partnership.

Reimbursements of Preformation Expenditures

- A transfer of money or other consideration by a partnership to a partner is not treated as part of the sale of property by the partner to the partnership under the facts and circumstances test to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, certain "preformation expenditures." Preformation expenditures are those capital expenditures that (1) are incurred during the two-year period preceding the transfer by the partner to the partnership, and (2) are incurred by the partner with respect to partnership organization and syndication costs or property contributed to the partnership, but only to the extent that the reimbursed capital expenditures do not exceed 20 percent of the property's fair market value at the time of the contribution. The 20 percent limit does not apply if the contributed property's fair market value does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution.

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Example #9: Reimbursement of Preformation Expenditures Under §707(a)(2)(B)

- Individual A uses $50,000 of his own funds to construct a building on a vacant lot that he has owned for several years. The value of the improved lot and building is $70,000. Individual A contributes the improved lot to the AB partnership within two years of the construction. Generally, AB can reimburse A for only $14,000 of the constructions cost (i.e., 20 percent of the improved property's $70,000 fair market value) under the preformation expenditures rule; any reimbursement in excess of this amount will be tested under the generally applicable two-year rule. However, where A's adjusted basis for the improved property is at least $58,334 (i.e., if A's basis for the unimproved lot was at least $8,334), then the fair market value of the improved property is no more than 120 percent of its adjusted basis (i.e., 120 percent of $58,334 is $70,001), the fair market value limitation is inapplicable, and the entire amount of the construction cost can be reimbursed to A under the preformation expenditures rule.

Exception: Qualified Liabilities

- A transfer of property by a partner to a partnership may be treated as a disguised sale if the contributing partner incurs debt in anticipation of the transfer and the partnership assumes the debt or takes the contributed property subject to the debt.

- If a transfer of property by a partner to a partnership is not otherwise treated as a sale, the partnership's assumption of or taking subject to a "qualified liability" in connection with the transfer also is not treated as part of a sale.

Definition of Qualified Liability

- A qualified liability is a liability that:
  - was incurred by the partner more than two years prior to the earlier date that the partner agreed in writing to transfer the property or the date that the partner transferred the property to the partnership, and that has encumbered the transferred property throughout the two-year period;
  - was not incurred in anticipation of the transfer of the property to the partnership;
  - is allocable to capital expenditures with respect to the property; or
  - was incurred in the ordinary course of the trade or business in which property transferred to the partnership is used or held but only if all of the assets related to that trade or business are transferred other than assets that are not material to the continuation of the trade or business.

Nonqualified Liabilities

- If a partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner’s share of that liability immediately after the partnership assumes or takes subject to the liability.

Example #10: Assumption of a Qualified Liability

- In Example (6) of Regulations §1.707-5(f), the contributed property has a value of $165, a basis of $75, and is subject to a $75 qualified liability. The contributor's post-contribution share of the liability is $25 under §1.707-5(b)(2) of the Regulations. The contributing partner receives a $30 cash distribution that is treated as sale proceeds. If the liability had been nonqualified, the contributor would have been treated as receiving additional consideration of $50 (i.e., $75 liability less the contributor's $25 post-contribution share of the liability) in connection with the liability assumption. The contributor's net equity percentage is equal to:

  - (1) the cash distribution to him, or $30, divided by
  - (2) the excess of the $165 value of the contributed property over the $75 qualified liability encumbering it, or $90, so that the net equity percentage is 33.3 percent.

- Applying this percentage to the amount of the qualified liability produces the amount of $25. Because $25 is less than the $50 amount computed under the nonqualified liability rules, the $25 figure is used. Therefore, the total sale proceeds received by the contributing partner is $55 (i.e., $30 cash distribution plus $25 consideration in connection with the liability assumption), and the contributor is treated as selling one-third of the property to the partnership for this amount, thus generating a $30 realized gain (i.e., $55 sales proceeds less $25 basis). The other two-thirds of the property, with a basis of $50, is treated as contributed to the partnership.

§ 707(a)(2)(B) Reporting Requirements

- Disclosure of Transfers Made Within Two Years. Disclosure to the Internal Revenue Service in accordance with Regulations §1.707-8 is required if:
  - A partner transfers property to a partnership and the partnership transfers money or other consideration to the partner within a two-year period (without regard to the order of the transfers);
  - The partner treats the transfers other than as a sale for tax purposes; and
  - The transfer of money or other consideration to the partner is not presumed to be a guaranteed payment for capital, is not a reasonable preferred return, and is not an operating cash flow distribution.

§ 704(c)(1)(B): Distributions of Contributed Property to Another Partner

- § 704(c)(1)(B) provides that if property contributed by one partner has built-in gain and that property is distributed to another partner within seven years of its contribution to the partnership, the contributing partner (or his successor) is treated as recognizing § 704(c) gain or loss as if the partnership had sold the property for its fair market value at the time of the distribution. The contributing partner’s outside basis is increased or decreased by the amount of gain or loss recognized as a result of the distribution. To avoid double recognition of that gain or loss, the partnership’s inside basis in the property is increased or decreased prior to the distribution to reflect the gain or loss recognized by the contributing partner.

Example #11: Disguised Sale Under §704(c)(1)(B)

- A contributes Blackacre with an adjusted basis of $12,000 and a fair market value of $20,000 and B contributes $20,000 cash to the equal AB partnership. Assume that three years later the partnership distributes Blackacre, then worth $23,000, to B. Under § 704(c)(1)(B), A is allocated the $8,000 precontribution gain just as if the partnership had sold the property instead of distributing it, and A would increase his outside basis by $8,000. In addition, Blackacre's basis would be $20,000 in the hands of B.

Same Property Exception

- § 704(c)(1)(B) does not apply if the contributed property is distributed back to the contributing partner.

§ 1031 Exception

- § 704(c)(2) provides relief to a contributing partner who receives a distribution of like-kind property (within the meaning of § 1031) within 180 days after the contributed property is distributed to another partner. The rationale here is that the contributing partner should not have to recognize gain under § 704(c)(1)(B) if he would have qualified for nonrecognition if the transaction had taken place outside the partnership.

Anti-Abuse

- The regulations under § 704(c)(1)(B) also contain an anti-abuse provision under which the statute and regulations must be applied in a manner consistent with the purpose of the section and the Service can recast a transaction for federal tax purposes to achieve appropriate tax results. For example, the regulations apply § 704(c)(1)(B) to a distribution that actually takes place after the statute's time limitation (i.e., more than seven years after the contribution of property), but where the partners took steps that were the functional equivalent of a distribution before the end of that period.

Distributions to Contributing Partner - § 737

- Under § 737, the general nonrecognition rule of § 731 does not apply if the distributee partner contributed appreciated property to the partnership within seven years of the date of distribution of other property to the same partner. § 737 requires recognition of gain but does not allow for loss recognition.

Amount of Gain Recognized.

- § 737 provides for gain recognition by a partner who contributed property with precontribution gain to the partnership upon distribution of other property to the same partner in any current or liquidating distribution to the extent of the lesser of:
  - the excess of the fair market value of property (other than money) distributed to the contributing partner over the partner's adjusted basis in his partnership interest, as reduced by any money distributed in the same transaction; or
  - the "net precontribution gain" of the partner. The term "net precontribution gain" means the amount of net gain (i.e., gain reduced by any loss) that the distributee partner would be required to recognize under § 704(c)(1)(B) if all property owned by the partnership immediately before the distribution that had been contributed by the distributee within seven years of the distribution was distributed to a partner other than the contributing partner.

Example #12: Gain Recognized Under §737

- A and B form partnership AB by each contributing property to AB on January 1, 1996. A contributes property Y, unimproved real estate having a basis of $10,000 and a fair market value of $100,000. B contributes property Z, unimproved real estate having a basis and fair market value of $100,000. A's basis in his partnership interest is initially $10,000 and B's basis is $100,000. On June 30, 1997, property Y is worth $150,000 and property Z is worth $110,000. On that date, when A's basis in his partnership interest is $10,000, the partnership distributes Property Z to A in a nonliquidating distribution. A's net precontribution gain as of June 30, 1997 is $90,000 (the amount of gain A would be required to recognize under §704(c)(1)(B) if property Y were distributed to B). The excess of the fair market value of property Z ($110,000) over A's adjusted basis in his partnership interest ($10,000) is $100,000. Thus, A is required to recognize $90,000, the amount of his precontribution gain, because it is less than the excess of the fair market value of the distributed property over his basis.

Character of Gain

- Under § 737(a), the character of the gain recognized by the distributee is determined in proportion to the distributee's net precontribution gain. In the preceding example, all of A's $90,000 of gain would be capital, assuming that Property Y is a capital asset in the partnership's hands.

Exception if Same Property is Distributed

- No gain is recognized by a distributee partner under § 737 if the same property contributed by the distributee is distributed to him.

Basis Adjustment

- Under § 737(c)(1), a distributee partner recognizing gain under § 737(a) increases the basis of his partnership interest to the extent of the gain recognition.

- Under § 737(c)(2), the partnership's basis in the contributed property is also appropriately adjusted to reflect gain recognized under § 737(a).

Constructive Sale Under §751(b)

- § 751(b) requires recognition of ordinary gain or loss when the partnership owns unrealized receivables or substantially appreciated inventory and there is a DISPROPORTIONATE DISTRIBUTION to a partner.

Definition of Unrealized Receivables

- The term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for:
  - Goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset; or
  - Services rendered, or to be rendered.
- For purposes of § 751, such term also includes § 1245 property, § 1250 property, and other similar items.

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Definition of Substantially Appreciated Inventory

- The term "inventory items" means:
  - Property of a partnership of the kind described in § 1221(1);
  - Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than capital assets and other than property described in § 1231;
  - Any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under subsection (a) of § 1248 (relating to gain on foreign investment company stock); and
  - Any other property held by the partnership which, if held by the selling or distributing partner, would be considered property of the type described above.

Definition of Substantially Appreciated

- Value of inventory exceeds 120% of adjusted basis of such inventory. But, inventory will be “disregarded” if the purpose for the acquisition was to avoid the 120% rule (IRC § 751(b)(3)(B)). In determining whether the partnership owns substantially appreciated inventory, one must include accounts receivable, whether or not realized, in applying the 120% test.

Definition of Disproportionate Distribution

- Generally, under §751(b) each partner is treated as owning interest in each partnership asset in proportion to his interest in the partnership. If a partner receives a distribution for property or money from a partnership which varies (i.e., increases or decreases) the amount of §751 assets which he was treated as owning immediately prior to the distribution, then a "DISPROPORTIONATE DISTRIBUTION" has occurred. Under such circumstances, the partner did not merely receive the amount of §751 assets which he was treated as owning prior to the distribution, rather he either received an interest in §751 assets in exchange for his interest in other assets or he received an interest in other assets in exchange for his interest in §751 assets.

Example #13: Simple 751(b) Disguised Sale

- Assume there is an equal 3-person partnership, ABC:

Type	Basis	Value
Accounts Receivable	-0-	$15,000
Cash	$15,000	$15,000
Liabilities & Equity		
A	$5,000	$10,000
B	$5,000	$10,000
C	$5,000	$10,000

- Assume that A, in complete liquidation of his interest, receives $10,000 cash. A received $5,000 more worth of cash than he was entitled to. A gave up a $5,000 interest in the unrealized accounts receivable. Since there was a $5,000 change in §751 Assets, §751(b) makes this a "Taxable Transaction" by overriding IRC §731(b).

Approach to §751 Distributions

- Are there §751 assets?
- Is there a Taxable Transaction?
- What is the basis to the partnership of properties?
- What is the basis to the partners of the properties?
- What are the properties exchanged for?
- What is the amount of gain recognized?

Example #14: Complex §751(b) Disguised Sales

- ABC is a three person equal partnership with the following balance sheet:

ASSETS

	Basis	FMV
Cash	$15,000	$15,000
Accounts Receivable	$9,000	$9,000
Inventory	$21,000	$30,000
Depreciable Property (no recapture potential)	$42,000	$48,000
Land	$9,000	$9,000
Total	$96,000	$111,000

LIABILITIES

	Basis	FMV
Current	$15,000	$15,000
Long Term	$21,000	$21,000

Example #14: Complex §751(b) Disguised Sales (con't)

CAPITAL

	Basis	FMV
A	$20,000	**$25,000**
B	$20,000	**$25,000**
C	**$20,000**	**$25,000**

Example #14: Complex §751(b) Disguised Sales (con't)

- Does ABC have §751 Assets?
- Unrealized accounts receivable. No.

- Substantial Appreciated Inventory. Yes.
  - Inventory.
    - Accounts receivable $9,000.
    - Inventory - basis $21,000 and value $30,000.
    - 120% test - total basis of inventory (which includes accounts receivable) is $30,000, 120% of which equals $36,000. $39,000 > $36,000 so 120% test is satisfied.

Example #14: Complex §751(b) Disguised Sales (con't)

- Was there a Taxable Transaction because there was a **DISPROPORTIONATE DISTRIBUTION**?
- A's share of partnership property:

	Basis	FMV
Cash	$5,000	$5,000
Accounts Receivable	$3,000	$3,000
Inventory	$7,000	$10,000
Depreciable Property	$14,000	$16,000
Land	$3,000	$3,000

- A receives $10,000 cash and $15,000 depreciable property and $12,000 debt relief
- A did not receive any interest in the accounts receivable or inventory with a fair market value of $13,000. These assets constitute § 751 Assets and, therefore, this was a DISPROPORTIONATE DISTRIBUTION in the amount of $13,000 which constitutes a Taxable Transaction. A also did not receive his full share of depreciable property which would have been $16,000. A only received $15,000.

Example #14: Complex §751(b) Disguised Sales (con't)

- Basis to Partner A in Assets Given Up
- Apply §732 as if A received his proportionate share of partnership assets in a current distribution immediately prior to the Disproportionate Distribution.

Cash	$5,000
Accounts Receivable	$3,000
Inventory	$7,000
Depreciable Property	$14,000
Land	$3,000

Example #14: Complex §751(b) Disguised Sales (con't)

Basis to Partnership in Assets Given Up

Cash	$5,000
Liabilities	$12,000

Example #14: Complex §751(b) Disguised Sales (con't)

- Properties Exchanged
- A received the following consideration:
  - $10,000 cash ($5,000 more than pro rata share)
  - $15,000 depreciable property ($1,000 less than his pro rata share).
  - Relief of $12,000 of liability.
- A, therefore, gave up his interest in:
  - $3,000 accounts receivable;
  - $10,000 of inventory;
  - $1,000 depreciable property; and
  - $3,000 land,

for a total of $17,000 in exchange for $5,000 cash and $12,000 relief of liabilities. Of this $17,000 exchange, $10,000 of inventory and $3,000 of accounts receivable constitute §751 assets. The parties could have designated the properties exchanged by agreement. (Regulations 1.751-1(g), ex. 3 and 4.)

Example #14: Complex §751(b) Disguised Sales (con't)

- Taxation to Partner

- A is treated as having sold his interest in §751 assets consisting of $10,000 of inventory and $3,000 of receivables for cash of $13,000 producing a taxable gain of $3,000. § 751(b) does not apply to the balance of the distribution. Before the distribution, A's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). This basis is reduced by $10,000, the basis attributed to the § 751 property treated as distributed to A and sold by him to the partnership.

- Thus, A has a basis of $22,000 for the remainder of his partnership interest. Since A received no more than his share of the depreciable property, none of the depreciable property constitutes proceeds of the sale under § 751(b). A did, however, receive more than his share of money. Therefore, the sale proceeds must, by process of elimination, be the consideration A received in exchange for his share of §751 Assets. Therefore, out of the total of $22,000 of cash and debt relief, $13,000 is allocable to the IRC §751(b) transaction and $9,000 is treated as a §731 distribution. In liquidation of the balance of A's interest, he received depreciable property and $9,000 in money ($22,000 less $13,000). Therefore, no gain or loss is recognized to A on the distribution. Under § 732(b), A's basis for the depreciable property is $13,000 (the remaining basis of his partnership interest, $22,000, reduced by $9,000, the money received in the distribution).

Example #14: Complex §751(b) Disguised Sales (con't)

- Taxation to the Partnership

- Since the partnership paid cash for the inventory and accounts receivable, it gets a cost basis therefor and no gain or loss is recognized to the partnership.

Example #14: Complex §751(b) Disguised Sales (con't)

- Character of Gain or Loss to A

- Character of gain or loss under §751 is determined by reference to the character of the asset in the hands of the party giving it up. Therefore, A would have to report $3,000 of ordinary income which represents the appreciation as the value of his share of the inventory.

Reporting Requirements (§6050K)

- If there is an exchange described in Code §751(a) of any interest in a partnership during any given calendar year, such partnership shall make a return for such calendar year stating: (i) the name and address of the transferee and the transferor, and (ii) any other information the Secretary may prescribe. In the case of any such exchange, the transferor of the partnership interest shall promptly notify the partnership of such exchange and the partnership shall not be required to make a return until so notified. Every partnership making such a return shall furnish to each person whose name is set forth in such return a written statement showing: (i) the name and address of the partnership making the return; and (ii) information shown on the return with respect to such person. Such statement is to be furnished no later than January 31 following the calendar year in which the exchange was made.

§708 Terminations and Effect on Disguised Sales

- § 708(b)(1)(B) terminating events are based upon the sales or exchanges of partnership interests. **For a termination to occur, there must be a sale or exchange of at least 50% of the total interests in partnership capital AND profits during a 12-month period.** The same interest sold more than once during the 12-month period is only counted once, although the later sale rolls forward the 12-month period.

Deemed Contribution and Distribution

- If a tax termination occurs, the partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership.

What About §704(c)(1)(B) and §737 Gains?

- Recall that §704(c)(1)(B) requires gain to be recognized by contributing partner if built-in gain property is distributed to another partner within seven years of contribution. Will §704(c)(1)(B) deemed distributions rule be triggered if a §708 termination occurs? No, per §1.704-4(c)(3).

- Recall that §737 requires net pre-contribution gain to be recognized by a contributing partner if built-in gain property is contributed and distributions are made to the contributing partner within 7 years of contribution. Will §737 be triggered if §708(b)(1)(B) termination occurs? No, per §1.737-2(a) no gain is triggered, but the §704(c) partner is still a §704(c) partner subject to §737 in the new partnership.

Mergers

- § 708(b)(2) provides special rules regarding partnership mergers, consolidations and divisions.

  - § 708(b)(2)(A) provides that in the case of the merger or consolidation of two or more partnerships, the Resulting Partnership shall be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the Resulting Partnership. All other partnerships terminate.

  - The regulations provide that if no group of members owns more than 50%, all of the other partnerships terminate.

Divisions

- As to partnership divisions, §708(b)(2)(B) provides that where a partnership divides into two or more partnerships, the Resulting Partnerships (other than any Resulting Partnership the members of which had an interest of 50 percent or less in the capital and profits of the Prior Partnership) shall, for purposes of this section, be considered a continuation of the Prior Partnership.

Forms of Merger/Division

- The Regulations recognize the following merger forms:

  - The "Assets-Over" form in which terminating partnerships are treated as transferring their assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership, which interests; and

  - The "Assets-Up" form in which terminating partnerships are treated as distributing their assets and liabilities to their partners in liquidation, and immediately thereafter the partners are treated as contributing such assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership.

Default to Assets Over

- The Assets-Up form applies whenever a terminated partnership distributes its assets to its partners in any manner that causes them to be treated as the owners of the assets under local law. Under these circumstances, the form is respected despite the transitory ownership of the distributed assets. The form is also respected even if the transfer involves assets (e.g., goodwill) that generally could not be held by the partners are undivided interest holders. However, a transaction case in the Assets-Up form will be recast as an Assets-Over transaction if the terminated partnership is not liquidated under local law. All mergers and consolidations that are not cast in the Assets-Up form are treated as Assets-Over transactions, regardless of their form (or lack of form) under local law. If a merger involves multiple terminating partnerships, each terminating partnership is analyzed separately, so that the Assets-Over form may apply to some transfers and the Assets-Up form to others.

Tax Effects of Choice

- The choice between the Assets-Up and Assets-Over forms controls for all income tax purpose and may have significant repercussions. For example, under the Assets-Over form, the tax basis of assets contributed to the resulting partnership is determined under §723, and thus should be generally unaltered by the transaction. By contrast, under the Assets-Up form, the basis of the assets of a terminating partnership are first determined under §§732(b) and 732(c) upon distribution to the partners, and then under §723 upon contribution to the continuing partnership—a process that can lead to significant basis changes, particularly if the terminating partnership has inside-outside basis differences.

Application of Disguised Sale Rules

- Finally, the choice of form will cause §§704(c)(1)(B) and 737 to apply in strikingly different ways. Under the Assets-Up form, both §§704(c)(1)(B) and 737 are applicable if any assets distributed to the partners were previously contributed to the distributing partnership within seven years of the distribution. By contrast, neither §704(c)(1)(B) nor §737 applies to a transaction cast in the Assets-Over form. However, the deemed contribution of assets from a terminating partnership may create a new layer of built-in gain for purposes of those rules.

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