TRANSACTIONS BETWEEN A PARTNER AND THE PARTNERSHIP

(a) IN GENERAL

Transactions between partners and partnerships are governed by Code Section 707. Congress amended this provision in the 1984 Tax Reform Act because partnerships were being used to circumvent the requirement to capitalize certain expenses and to circumvent other rules and restrictions concerning various expenses by making allocations of income and corresponding distributions in place of direct payments for property or services. Similarly, taxpayers deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed (or preceded) by a related distribution of partnership property (including money). In addition, several court decisions allowed tax-free treatment in cases that were economically indistinguishable from sales of property by the partner to a partnership or to another partner.

EXAMPLE: Suppose partner X performs services for the XYZ partnership in exchange for a fixed amount of money. If that amount is treated as a distribution instead of compensation, there is no gain or loss to the partnership or to X (assuming X’s outside basis can absorb the distribution). There is a reduction, under Code Section 733, in X’s outside basis. If, though, the same payment had been made to a non-partner, the recipient would have compensation income on the transaction, and, unless required to be capitalized, the partnership takes a business expense deduction under Code Section 162. Under Code Section 707, X has compensation income, and the partnership either deducts the compensation expense under Code Section 162 or capitalizes it under Code Section 263.

(b) TRANSACTIONS OUTSIDE THE PARTNERSHIP

Generally, if a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, the transaction is treated as occurring between the partnership and a non-partner. Code Section 707(a)(1). Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership, the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership. Reg. Section 1.707-1(a).

Where a partner retains the ownership of property but allows the partnership to use the property for partnership purposes (for example, to obtain credit or to secure firm creditors by guaranty, pledge, or other agreement) the transaction is treated as one between a partnership and a partner not acting in his capacity as a partner. However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions covered by Code Section 707. In all cases, the substance of the transaction governs rather than its form. Reg. Section 1.707-1(a).
(c) PAYMENTS TO PARTNERS FOR PROPERTY OR SERVICES

The IRS has regulatory authority to treat a transfer of property by a partner to a partnership and a related direct or indirect allocation and distribution to the partner as a sale or exchange if the transfers are properly viewed together as occurring between a partnership and a partner acting in a capacity other than as a partner. Code Section 707(a)(2)(A). It also has regulatory authority to identify those transactions that, though structured as contributions and distributions under Code Sections 721 and 731 are more properly treated as sales or exchanges between a partnership and a partner acting in a capacity other than as a member of the partnership. Code Section 707(a)(2)(B).

Under Code Section 707(a)(2)(B), if there has been a direct transfer of property by a partner to a partnership followed by a transfer of money by the partnership to the partner, the transaction may be regarded as a sale of the property by the partner to the partnership.

EXAMPLE 1: Two individuals agree to form a partnership for the purpose of constructing federally supported, low-cost housing. Individual A contributes to the partnership real estate having an adjusted basis of $40,000 and a fair market value of $100,000. Individual B makes only a nominal contribution of cash. The partners agree that they will divide all profits and losses equally. In addition, they agree that $100,000 will be distributed to A once the construction loan is obtained. In this case, there has been a direct transfer of property to the partnership and when the partnership subsequently distributes some of its borrowed funds to A, there is a direct transfer of money from the partnership to A. Accordingly, if these two transfers are recharacterized under Code Section 707(a)(2)(B), A will be taxed under Code Section 707(a)(1) as if she sold the real estate to the partnership. As a result, A will recognize gain on the transfer, and the partnership will take a cost basis in the property.

EXAMPLE 2: A taxpayer contributed assets to an LLC. The LLC then distributed money borrowed by the LLC to the taxpayer. This transaction was in substance a disguised sale of the assets to the LLC and should be treated as such. In this case, the portion of the distribution that was debt financed, which the taxpayer argued should not be treated as consideration in a disguised sale, in addition to the portion of the distribution that was not debt financed, was treated as consideration in a disguised sale. CCA 200246014.

OBSERVATION: The IRS has stated that it is considering issuing proposed regulations under Code Section 707(a)(2)(B). Prior to the issuance of regulations, the determination of whether a transaction is a disguised sale of a partnership interest should be made on the basis of the statute and its legislative history. Notice 2001-64, 2001-2 C.B. 319.

The IRS has advised that Code Section 707(a)(2)(B) can also apply to indirect transactions. In TAM 200004036, the IRS applied Code Section 707(a)(2)(B) to find a disguised sale of a note in a situation where a partnership was formed by one subsidiary corporation and money was transferred through another corporation to the common parent.
Code Sections 707(a)(2)(A) and 707(a)(2)(B) are similar in that both are triggered by a transfer to the partnership of certain property and a related distribution from the partnership to a partner. What distinguishes Code Section 707(a)(2)(A) from Code Section 707(a)(2)(B) is the requirement in Code Section 707(a)(2)(A)(ii) that the contributing/distributee partner receive an allocation of income to go along with the distribution of money or property. By reason of this allocation requirement, the contributing/distributee partner will recognize income on the transaction, and transactions described in Code Section 707(a)(2)(A) cannot represent attempts to reduce the tax burden imposed on the contributing/distributee partner. Rather, such transactions may represent an attempt by the partnership to avoid the capitalization requirement of Code Section 263.

EXAMPLE: Suppose the P partnership constructs a commercial office building. The architect, whose normal fee is $40,000, contributes cash for a 25 percent interest in the partnership and receives in addition a gross income allocation of $20,000 per year for the first two years of the partnership. Further, the partnership agreement provides that the architect will be distributed $20,000 of cash in each of the first two years in addition to her share as partner. For ease of illustration, assume that the partnership generates rental income each year of $120,000.

This gross income allocation and distribution produces the same tax consequences to the architect as a salary of $40,000. The architect must report $40,000 of income over the first two years in addition to her 25 percent distributive share, and the architect's outside basis and capital account each enjoys a net increase equal to her general 25 percent interest in the partnership. That is, after two years the architect will have included $40,000 by reason of the special gross income allocation as well as $50,000 (25 percent of the remaining $100,000 each year) as distributive share of partnership taxable income. In addition, the architect's outside basis will have increased by $90,000 by reason of the special allocations and one-quarter distributive shares and will have decreased by $40,000 by reason of the distributions, for a net increase of $50,000.

Consider the effect of the gross income allocation on the partnership generally. Had the architect been paid a straight salary, that salary would have been capitalizable as part of the cost of the building. Reg. Section 1.263(a)-2(d). As a result, the architect would have reported $40,000 of compensation income, and the partnership would have had $100,000 of income to be allocated among its partners (of which $25,000 would have been the architect's distributive share). Because the architect was compensated indirectly with the special gross income allocation and distribution, though, the partnership has only $80,000 per year to allocate among its members. The money used to pay the architect's fee thus is not reported by the partners in their distributive shares, and that is the equivalent of including those funds and then deducting the fee. In other words, allocating income to one partner and away from the others is equivalent to paying the same amount of income as a deductible expense.

Not all allocations are subject to recharacterization under Code Section 707(a)(2)(A). The legislative history of Code Section 707(a)(2)(A) indicates that a partner is acting as a third party to the extent that
the partner's profit from a transaction is assured without regard to the success or failure of the joint undertaking. An allocation of net partnership income ordinarily should not fall within the scope of Code Section 707(a)(2)(A) because net income is dependent on the economic success of the partnership venture. Allocations of gross partnership income do not share this element of entrepreneurial risk and therefore are more liable to challenge under Code Section 707(a)(2)(A). Indeed, from this perspective the effect of Code Section 707(a)(2)(A) is to identify those allocations and distributions that together constitute disguised guaranteed payments.

Congress identified several specific factors that should be considered under Code Section 707(a)(2)(A). S. Rep. 169, 98th Cong., 2d Sess. at 227-228 (1984). The most important factor is the extent to which the distribution is subject to appreciable risk. Even an allocation of net income can be virtually risk free as to both fact or payment and amount if the partnership's income stream is assured. For example, if the partnership owns property rented on a long-term lease to a credit-worthy lessee, an allocation of a fixed percentage of the partnership's net income might be tantamount to a risk-free allocation of a specific dollar sum. Capped allocations -- allocations equal to the lesser of a percentage of the partnership's net income or a fixed annual sum -- should easily be classified as falling within Code Section 707(a)(2)(A).

The second factor to be considered is the duration of the distributee partner's status as a partner. If the distributee's status as a partner is transitory, the allocation and distribution are more likely to be recharacterized as a fee for services or property. Even if the distributee's status as a partner is not transitory, if the distributee's continuing interest in the partnership is small compared with the special allocation and distribution, the transaction is likely to fall within Code Section 707(a)(2)(A). Indeed, the legislative history indicates that this factor is particularly important if the special allocation lasts for only a short period of time. Thus, a special allocation of $25,000 for one year is ripe for recharacterization if the value of the partner's continuing profits interest is substantially less than $25,000 annually. Of course, no recharacterization is possible unless there is a related transfer of property or services to the partnership, payment for which would be capitalizable in full or in part.

Other factors identified by the legislative history include the proximity in time of the contribution of services or property and the distribution, the effect of the transaction on providing tax benefits to the partnership, and whether the contribution was booked in at less than fair market value.

(d) TRANSFERS TREATED AS DISGUISED SALES

In general. A transfer of property to a partnership by a partner followed by a distribution from the partnership to the partner is treated as a disguised sale if the distribution to the partner would not have been made but for the partner's transfer of property and, if the two transactions are not simultaneous, the subsequent transaction is not dependent on the entrepreneurial risks of the partnership. Reg. Section 1.707-3(b)(1).
Determining if transfer is a disguised sale. The determination of whether a transfer is a disguised sale is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances depends on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists. Reg. Section 1.707-3(b)(2). Among the facts and circumstances that may tend to prove the existence of a sale are the following:

(1) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(2) that the transferor has a legally enforceable right to the subsequent transfer;

(3) that the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(4) that any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(5) that any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

(6) that a partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(7) that the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(8) that partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(9) that the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(10) that the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner. Reg. Section 1.707-3(b)(2).
If a transfer to the partnership and a distribution to the transferee-partner are made within two years, the two transactions are presumed to constitute a sale. Reg. Section 1.707-3(c)(1). Conversely, contributions and distributions separated by more than two years are presumed not to constitute a sale. Reg. Section 1.707-3(d).

In either situation, however, the particular facts surrounding the transactions can overcome the presumption. In particular, distributions of operating cash flow generally will not be recharacterized as part of a disguised sale. Reg. Section 1.707-4(b).

EXAMPLE: C transfers undeveloped land to the CD partnership in exchange for an interest in the partnership. CD intends to construct a building on the land. At the time the land is transferred to CD, it is unencumbered and has an adjusted tax basis of $500,000 and a fair market value of $1 million. The partnership agreement provides that, upon completing construction of the building, CD will distribute $900,000 to C. If, within two years of C's transfer of land to CD, a transfer is made to C pursuant to the provision requiring a distribution upon completion of the building, the transfer is presumed to be part of a sale of the land to CD. C may rebut the presumption that the transfer is part of a sale if the facts and circumstances clearly establish that (1) the transfer to C would have been made without regard to C's transfer of land to CD; or (2) the partnership's obligation or ability to make this transfer to C depends, at the time of the transfer to the partnership, on the entrepreneurial risks of partnership operations.

If, in the example above, the partnership can fund the transfer of cash to C only to the extent that permanent loan proceeds exceed the cost of constructing the building, the fact that excess permanent loan proceeds will be available only if the cost to complete the building is significantly less than the amount projected by a reasonable budget would be evidence that the transfer to C is not part of a sale. Similarly, a condition that limits the amount of the permanent loan to the cost of constructing the building (and thereby limits the partnership's ability to make a transfer to C) unless all or a substantial portion of the building is leased would be evidence that the transfer to C is not part of a sale, if a significant risk exists that the partnership may not be able to lease the building to that extent. Another factor that may prove that the transfer of cash to C is not part of a sale would be that, at the time the land is transferred to the partnership, no lender has committed to make a permanent loan to fund the transfer of cash to C.

Facts indicating that a transfer of cash is not part of a sale, however, may be offset by other factors. An offsetting factor to restrictions on the permanent loan proceeds may be that the permanent loan is to be a recourse loan and certain conditions to the loan are likely to be waived by the lender because of the creditworthiness of the partners or the value of the partnership's other assets. Similarly, the factor that no lender has committed to fund a particular transfer of cash may be offset by facts establishing that the partnership is obligated to attempt to obtain such a loan and that its ability to obtain such a loan is not significantly dependent on the value that will be added by successful completion of the building, or that the partnership reasonably anticipates that it will have (and will utilize) an alternative source to fund the transfer of cash if the permanent loan proceeds are inadequate.
EXAMPLE: E and F are equal partners in the EF general partnership. The partnership owns two pieces of unimproved real estate. Parcel 1 has a fair market value and adjusted basis of $500,000, while parcel 2 has a fair market value and adjusted basis of $1,500,000. E transfers parcel 3, also unimproved real estate, to the partnership in exchange for an increased interest in profits and losses. After the contribution of parcel 3, E's interest in the partnership is increased to two-thirds while F's interest is decreased to one-third. At the time of the contribution, parcel 3 has a fair market value of $1 million and an adjusted basis of $900,000. Immediately after E contributes parcel 3, the partnership sells parcel 1 for $500,000 and distributes the proceeds to the partners in accordance with their new interests in the partnership -- $333,333 is distributed to E, and $166,667 is distributed to F.

Because E's transfer of parcel 3 occurs within two years of the distribution by the partnership of the proceeds from the sale of parcel 1, the contribution and distribution are presumed to constitute a sale. However, part of that presumption is rebutted by the facts surrounding the transaction. Had E not contributed parcel 3, E would have had a one-half interest in the partnership and presumably would have been entitled to receive half of the sale proceeds from the partnership's disposition of parcel 1. Accordingly, of the $333,333 actually distributed to E, only $83,333 (that being the excess of the actual distribution (i.e., $333,333) over what would have been distributed had E not contributed parcel 3 (i.e., $250,000)) was dependent on E's contribution of parcel 3. Thus, only $83,333 is treated as sale proceeds to E from the disguised sale of parcel 3. That is, E is treated as selling 8.33 percent of parcel 3 to the partnership in exchange for $83,333 and as contributing 91.67 percent of parcel 3 in exchange for the increased partnership interest. Because 8.33 percent of E's $900,000 adjusted basis in parcel 3 equals $74,970, E must recognize a gain on the deemed sale of $8,363. Consistent with this sale treatment, W should increase his outside basis by the gain recognized under Code Section 707(a)(2)(B), and the partnership should increase its basis in parcel 3 by the same amount.

In applying the disguised sale rules, transfers resulting from a Code Section 708(b)(1)(B) partnership termination are disregarded. Reg. Section 1.707-3(a)(4).

Disclosure requirement. Disclosure to the IRS is required if:

(1) A partner transfers property to a partnership and the partnership transfers money or other consideration to the partner with a two-year period (without regard to the order of the transfers); and

(2) the partner treats the transfers other than as a sale for tax purposes; and

(3) 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. Reg. Section 1.707-3(c)(2).
Disguised sales from a partner to the partnership are but one of many transactions to which Code Section 707(a)(2)(B) applies. A contribution of money by a partner to the partnership followed by a distribution of appreciated property to that partner could, under Code Section 707(a)(2)(B), be recharacterized as a disguised sale of the property by the partnership to the partner. However, in certain circumstances, they may be.

### Timing and Treatment of Disguised Sale for Purposes of Other Code Provisions

A transfer that is treated as a sale under the disguised sale rules is treated as a sale for all purposes of the Internal Revenue Code (e.g., Code Sections 453, 483, 1001, 1012, 1031 and 1274). The sale is considered to take place on the date that, under general principles of federal tax law, the partnership is considered the owner of the property. If the transfer of money or other consideration from the partnership to the partner occurs after the transfer of property to the partnership; the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other consideration. Reg. Section 1.707-3(a)(2).

### Application of Rules Where Partnership or Partner Is Determined Not to Exist

If a person purports to transfer property to a partnership in a capacity as a partner, the disguised sale rules apply for purposes of determining whether the property was transferred in a disguised sale, even if it is determined after the application of the rules that the person is not a partner. In addition, if after the application of the disguised sale rules to a purported transfer of property to a partnership, it is determined that no partnership exists because the property was actually sold, or it is otherwise determined that the contributed property is not owned by the partnership for tax purposes, the transferor of the property is treated as having sold the property to the person (or persons) that acquired ownership of the property for tax purposes. Reg. Section 1.707-3(a)(3).

### (e) Guaranteed Payments and Preferred Returns

**In General.** Code Section 707(a)(2)(B) can also address more complex transactions in which a contribution and distribution might closely resemble a partial sale to another partner followed by mutual contributions to the partnership. These more complex transactions can appear in unexpected settings. Guaranteed payments to a partner for the use of capital are unlikely to be recharacterized under Code Section 707(a)(2)(B) as part of a disguised sale because they are taxable to the distributee under Code Section 707(c).

**What constitutes a guaranteed payment.** A party's characterization of a payment as a guaranteed payment for capital will not control in determining whether a payment is, in fact, a guaranteed payment for capital. The term "guaranteed payment for capital" means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital. For this purpose, one or more payments are not 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 provide the partner with a return on an investment in the partnership. Reg. Section 1.707-4(a)(1)(i).

**Reasonable guaranteed payments.** A transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital, is
determined without regard to the income of the partnership, and is reasonable is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale. Reg. Section 1.707-4(a)(1)(ii).

Unreasonable guaranteed payments. A transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital but that is not reasonable is presumed not to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is a guaranteed payment for capital. A transfer that is not a guaranteed payment for capital is subject to the disguised sale rules. Reg. Section 1.707-4(a)(1)(iii).

What constitutes a preferred return. A transfer of money to a partner that is characterized by the parties as a preferred return and that is reasonable is presumed not to be a sale of property to the partnership unless the facts and circumstances (including the likelihood and expected timing of the subsequent allocation of income or gain to support the preferred return) clearly establish that the transfer is part of a sale. The term "preferred return" means 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, to the extent available, by an allocation of income or gain. Reg. Section 1.707-4(a)(2).

Reasonable preferred returns and guaranteed payments. A transfer of money to a partner that is characterized as a preferred return or guaranteed payment for capital is reasonable only to the extent that the transfer is made to the partner pursuant to a written provision of the partnership agreement providing 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. Reg. Section 1.707-4(a)(3)(i).

A transfer of money that is made to a partner during any partnership taxable year and is characterized as a preferred return or guaranteed payment for capital is 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 by the safe harbor interest rate for that year. Reg. Section 1.707-4(a)(3)(ii).

The safe harbor interest rate for a partnership's taxable year equals 150 percent of the highest applicable federal rate, at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year. Reg. Section 1.707-4(a)(3)(ii).

A partner's unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other
than transfers of money that are presumed to be guaranteed payments for capital, transfers of money that are reasonable preferred returns, and operating cash flow distributions (which are discussed in Section 404.5.7.2). Reg. Section 1.707-4(a)(3)(ii).

(f) PRESUMPTION REGARDING OPERATING CASH FLOW DISTRIBUTIONS

In general. Notwithstanding the presumption relating to transfers made within two years of each other, an operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale. Reg. Section 1.707-4(b)(1).

Operating cash flow distributions defined. One or more transfers of money by the partnership to a partner during a taxable year of the partnership are operating cash flow distributions to the extent that those transfers are not presumed to be guaranteed payments for capital, are not reasonable preferred returns, are not characterized by the parties as distributions to the partner acting in a capacity other than as a partner, and to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner's percentage interest in overall partnership profits for that year or the partner's percentage interest in overall partnership profits for the life of the partnership. Reg. Section 1.707-4(b)(2)(i).

The net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership's business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other non-cash charges deducted in determining such taxable income and decreased by:

1. Principal payments made on any partnership debt;
2. Property replacement or contingency reserves actually established by the partnership;
3. Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow; and
4. Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

Operating cash flow distribution safe harbor. For any taxable year, in determining a partner's operating cash flow distributions for the year, the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with that taxable year. This provision is merely intended to provide taxpayers with a safe harbor and not to preclude a taxpayer from using a different percentage under the rules discussed above. Reg. Section 1.707-4(b)(2)(ii).
Tiered partnerships. In the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership applying principles discussed above so that the amount of the upper-tier partnership's operating cash flow distributions is neither overstated nor understated. Reg. Section 1.707-4(b)(2)(iii).

Example of guaranteed payment treated as being part of a sale

The following example illustrates a facts and circumstances situation in which a guaranteed payment is treated as being, in reality, part of a sale.

EXAMPLE: C and D form a general partnership. C contributes property with adjusted basis of $20,000 and fair market value of $100,000 while D contributes no property but agrees to be responsible for the day-to-day management of the partnership's operations. The partners agree that all tax items will be allocated 75 percent to C and 25 percent to D. They also agree that all cash flow will be distributed in the same portion except that C will receive a guaranteed payment of $8,333 per year for the first four years. By the terms of the partnership agreement, the guaranteed payment will come out of D's cash flow only, and if the partnership does not generate sufficient revenue to meet its guaranteed payment obligation to C, D will contribute sufficient funds to meet that obligation.

Even if $8,333 is a reasonable annual payment for the use of C's contributed capital, the regulations provide that C's preferential distributions will be treated as part of a disguised sale. Note that if the form of the guaranteed payments is respected, the partnership will be entitled to an interest deduction of $8,333 each year for the first four years, or $33,332 total. Because C is allocated 75 percent of all partnership deductions, C will be allocated an interest deduction equal to 75 percent of $33,332, or $24,999. Thus, one effect of the nominal guaranteed payments is that C's capital account will be reduced by $24,999.

By reason of C's contribution of property to the partnership, C's capital account begins at $100,000. By reason of the nominal guaranteed payments, C's capital account is reduced by approximately 25 percent of its value. Thus, the net effect of the contribution and distributions is to credit C's capital account with about $75,000, which is precisely C's general percentage in partnership tax items and distributions of cash flow. Because the economic costs of C's preferential distributions are borne entirely by D, the regulations conclude that C should be treated as having sold one-quarter of the property to D. Further, had D borrowed $25,000 from C repayable over four years, the annual loan payment (principle plus interest) would be approximately the amount of the nominal guaranteed payments. Thus, the transaction is recharacterized as if C had sold to D a one-quarter interest in the contributed property immediately prior to the formation of the partnership. The nominal guaranteed payments made to C will be reclassified as Code Section 731 distributions made to D and then paid over to C as repayment by D of the $25,000 loan.
(g) ACCUMULATION OF GUARANTEED PAYMENTS, PREFERRED RETURNS, AND OPERATING CASH FLOW DISTRIBUTIONS

Guaranteed payments for capital, preferred returns, and operating cash flow distributions presumed not to be part of a sale under the disguised sale rules do not lose the benefit of the presumption by reason of being retained for distribution in a later year. Reg. Section 1.707-4(c).

A transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under the disguised sale rules to the extent that the transfer is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that:

(1) are incurred during the two-year period preceding the transfer by the partner to the partnership; and

organization and syndication costs or property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the contribution.

A corporation that acquires assets of another corporation in a Code Section 381 transaction (a transaction in which tax attributes carry over to a successor corporation) succeeds to the status of the other corporation for purposes of applying the exception for reimbursements of preformation expenditures and determining whether a liability is a qualified liability under the partnership disguised sale provisions. Rev. Rul. 2000-44, 2000-2 C.B. 336. See Section 208.19 for discussion of Code Section 381 transactions.

(i) LIMITATIONS APPLICABLE TO CONTROLLED PARTNERSHIPS

In general. Code Section 707(b) imposes two limits (discussed below at Sections 5.7.9.2. and 5.7.9.3.) on a controlling partner's ability to exploit her position in the partnership for tax advantages. In this context, a controlling partner is one who owns (directly or indirectly) more than 50 percent of the capital or profits of the partnership. While determining a partner's share of capital should be purely mechanical, determining a partner's share of profits is more difficult in any complex partnership that specifically allocates some profit items. This aspect of Code Section 707(b) is one more example of how some parts of Subchapter K reflect a surprising ignorance of the workings of partnership taxation. Note that a partner's share of both capital and profits include the capital and profits interests of all related parties, where related parties are defined in Code Section 267(c). Code Section 707(b)(3).

Disallowed Losses. No deduction is allowed for losses from sales or exchanges of property, directly or indirectly, between a partnership and a controlling partner. Code Section 707(b)(1). This loss disallowance rule can apply to sales of property from partnerships to a related party as well as to sales of property to partnerships from a related party.

Where a loss on the sale of partnership property is disallowed under this
loss disallowance rule, the basis of each partner's interest in the partnership is decreased (but not below zero) under Code Section 705(a)(2) by the partner's share of that loss. Rev. Rul. 96-10, 1996-1 C.B. 138.

Similarly, if gain from the sale of partnership property is not recognized under Code Sections 707(b)(1) and 267(d), the basis of each partner's interest in the partnership is increased under Code Section 705(a)(1) by the partner's share of that gain.

**EXAMPLE 1:** The AB general partnership has two partners, A and B. Partner A has a capital account and outside basis of $25,000 while partner B has a capital account and outside basis of $75,000. Assume the partnership agreement allocates all tax items 25 percent to A and 75 percent to B, and the partnership owns Blackacre with adjusted basis and book value of $40,000 as well as cash of $60,000. If the partnership sells Blackacre to B for its current fair market value of $30,000, the following tax consequences occur.

The sale produces a book loss to the partnership of $10,000, and under the partnership agreement that loss is allocated $2,500 to A and $7,500 to B. Accordingly, A's capital account is reduced to $22,500, and B's capital account is reduced to $67,500. While the partnership realizes a tax loss of $10,000 on the sale, that loss is disallowed by application of Code Section 707(b)(1) because the purchaser (B) is in control of the selling partnership.

Despite the absence of a recognized tax loss, the partners must reduce their outside bases by their shares of the realized but unrecognized tax loss. Because the operation of Code Section 707(b)(1) disallows the loss entirely (rather than just deferring it), the loss is properly treated as a non-deductible, non-capitalizable expenditure. Or, in the words of Rev. Rul. 96-10, 1996-1 C.B. 140, this item falls within Code Section 705(a)(2)(B) because it "has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income." Thus, A's outside basis is reduced to $22,500 and B's outside basis is reduced to $67,500.

B's basis in Blackacre is its cost to B of $30,000. However, if B subsequently sells Blackacre at a gain, B may use the loss disallowed to the partnership to offset any gain realized on the sale. For example, if B eventually sells Blackacre for $45,000, B's recognized gain will be only $5,000. The effect of this rule is to permit B to use not only that part of the loss denied to B under Code Section 707(b)(1), but also to use the remaining portion of the loss denied to A under that section as well.

The following example considers the reverse transaction in which a controlling partner sells loss property to the partnership.

**EXAMPLE 2:** Suppose partner B in the preceding example sells Whiteacre to the partnership for its fair market value of $8,000 when Whiteacre has an adjusted basis of $10,000 in B's hands. Assume that at the time of the sale A's outside basis and capital account equal $22,500 while B's outside basis and capital account equal $67,500.
By virtue of Code Section 707(b)(1), the loss of $2,000 realized by B on the sale goes unrecognized, and the partnership takes a cost basis of $8,000 in Whiteacre. As before, if Whiteacre is subsequently sold at a gain, only so much of the gain as exceeds the disallowed loss must be recognized. Thus, if the partnership subsequently sells Whiteacre to a third party for its then fair market value of $14,000, the partnership realizes a book gain of $6,000 over its acquisition cost of $8,000. However, the partnership recognizes only $4,000 of tax gain by virtue of the penultimate sentence in Code Section 707(b)(1). How should this gain be allocated among the partners?

In the absence of any special allocation, B will be allocated 75 percent of the $4,000 tax gain, or $3,000. However, the partnership's tax gain is only $4,000 rather than $6,000 because of the prior tax loss that B sustained but was not allowed to deduct. Accordingly, when that disallowed loss reappears in the form of an income offset to the partnership, arguably it should benefit the partner who generated it; in other words, it should benefit B. Thus, B should be taxed on her share of the book gain (that is, on 75 percent of $6,000, or $4,500) less that $2,000 income offset, for a net share of $2,500. The remaining $1,500 tax gain recognized by the partnership would then be allocable to A. Note that the effect of this approach is to tax A as she would be taxed had B's loss not been disallowed. The $1,500 tax gain allocated to B is precisely 25 percent of the partnership's book gain on the subsequent sale.

Put another way, the disposition of Whiteacre by the partnership for $14,000 produces book income of $6,000, taxable gain of $4,000, and tax-exempt income of $2,000. Should the partners be permitted (perhaps even required) to allocate all the exempt income to B because it was B's disallowed loss that generated it? Assuming the partners in fact agree to allocate all the exempt income as well as $2,500 of the taxable income to B and the remaining $1,500 of taxable income to A, do these allocations lack substantiality because they do not affect the actual dollars either partner will receive but only affect the partners' tax positions? While there is no direct authority on this point, it would seem that allocating to B the tax benefit of the income offset generated by B's prior disallowed loss should be permissible.

Code Section 707(b)(1) also provides that, in the case of a subsequent sale or exchange by a transferee described in Code Section 707(b)(1), Code Section 267(d) applies as if the loss were disallowed under Code Section 267(a)(1). Basically, Code Section 267(d) provides that, if a taxpayer acquires property by sale or exchange from a transferor who, on the transaction, sustained a loss not allowable as a deduction by reason of Code Section 267(a)(1), then any gain realized by the taxpayer on a sale or other disposition of the property is recognized only to the extent that the gain exceeds so much of the loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer.

Where gain from the sale of partnership property is not recognized under this provision, the basis of each partner's interest in the partnership is increased under Code Section 705(a)(1) by the partner's share of that gain. Rev. Rul. 96-10, 1996-1 C.B. 138.
Capital gains. Gains from sales and exchanges between a partnership and its controlling partner (or between commonly controlled partnerships) are taxable as ordinary income if the transferred property is not a capital asset in the hands of the transferee. Code Section 707(b)(2).

Ownership of a capital or profits interest. For purposes of applying these rules, the ownership of a capital or profits interest in a partnership is determined in accordance with the rules for constructive ownership of stock provided in Code Section 267(c) (other than Code Section 267(c)(3)). Code Section 707(b)(3).

Guaranteed payments. Payments to a partner for services or the use of capital, to the extent determined without regard to partnership income, are considered made to one who is not a member of the partnership, but only for purposes of Code Section 61(a) (relating to gross income) and, subject to Code Section 263, for purposes of Code Section 162(a) (relating to trade or business expenses).