

SELECTED TAX CONSIDERATIONS

IN

REAL ESTATE TRANSACTIONS:

DISGUISED SALES

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TAX PLANNING FOR THE EXTRACTION OF EQUITY FROM PARTNERSHIPS

I. INTRODUCTION

The contextual framework of the Code provides that contributions of property to and distributions of property from a partnership generally do not constitute a taxable event for either the partnership or its partners; provided, however, that due to the potential for abuse, the Code and Regulations provide many rules for when these transactions will be taxable in whole or part.

There are a myriad of situations in which such transactions may be taxable. Given the relatively short time frame we have for this seminar, we will focus on three main themes: (i) the contribution of Real Property to a Partnership and the distribution of consideration to the contributing partner and/or assumption of liabilities of the partnership; (ii) the anti-mixing bowl rules of Section 704(c)(1)(B); and (iii) the anti-mixing bowl rules of Section 737.

The subject matter of this article is by its nature extremely complex and constantly evolving and the contentions of this article are intended to provide an overview of the subject and should not be taken or construed in any manner to apply to any specific situation or factual circumstances, as such, I strongly suggest that anyone reading this article or attending the seminar consult with their legal and accounting professionals for any specific questions or transactions.

II. PARTNERSHIP DISGUISED SALE RULES

A. Background

1. Section 707(a)(2) was enacted as part of the Tax Reform Act of 1984. P.L. 98-369
 - a. Section 707(a)(2)(A) provides that if a partner performs services for or transfers property to a partnership, and there is a related allocation of income and distribution of cash or property to such partner, then the transaction will be treated as a transaction between the partnership and a person who is not a partner if, under all the facts and circumstances, the transaction is more properly characterized as a payment to a partner acting in a non-partner capacity.
 - b. Section 707(4)(2)(B) provides that if there is a transfer of money or other property by a partner to a partnership, and there is a related transfer of money or other property by the partnership to such partner (or another partner), the transfers will be treated as occurring between the partnership and a person who is not a partner if, when viewed together, the transfers are properly characterized as a sale or exchange of property.

B. Identifying Disguised Sales

1. "Facts and Circumstances" Test

- a. When a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner a "sale" of the property to the partnership if, based on all the facts and circumstances, "(i) the transfer of money or other consideration would not have been made but for the transfer of property, and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations." Treas. Reg. § 1.707-3(b)(1). Whether the distribution to the partner occurs before or after the contribution to the partnership is immaterial. Treas. Reg. § 1.707-3(c)(1).
- b. The facts and circumstances existing on the date of the earliest transfer (i.e., contribution or distribution) are "generally" the relevant ones to be considered. Treas. Reg. § 1.707-3(b)(2).
- c. The treasury regulations contain a nonexclusive list of 10 factors that tend to determine the "facts and circumstances" to show the existence of a sale pursuant to Section 707(a)(2)(B). The factors are as follows:
 - (i) Reasonable Contents. The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;
 - (ii) Legally Enforceable Right. The transferor has a legally enforceable right to the subsequent transfer;
 - (iii) Security. The partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;
 - (iv) Contribution. Any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;
 - (v) Loans. Any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

- (vi) Partnership Debt. The partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);
- (vii) Liquid Assets. The partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);
- (viii) Allocations, Distributions and Control. The partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;
- (ix) Proportionality. The transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and
- (x) Obligation to Repay. The partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner. Treas. Reg. § 1.707-3(b)(2)(i)-(x).

2. Two-Year Presumption

- a. If within a two-year period a partner transfers the property to a partnership and the partnership transfers money or other consideration to the partner, there is a presumption that a sale has taken place. The order of the transfer is immaterial. Treas. Reg. § 1.707-3(c)(1).
- b. This presumption is rebuttable only if "the facts and circumstances clearly establish that the transfers do not constitute a sale."
- c. If the contribution by and distribution to the partner are more than two years apart, the transfers are presumed not to be a sale of the contributed property, "unless the facts and circumstances clearly establish that the transfers constitute a sale." Treas. Reg. § 1.707-3(d).

d. What constitutes facts to "clearly establish" that either a favorable or unfavorable presumption should be rebutted?

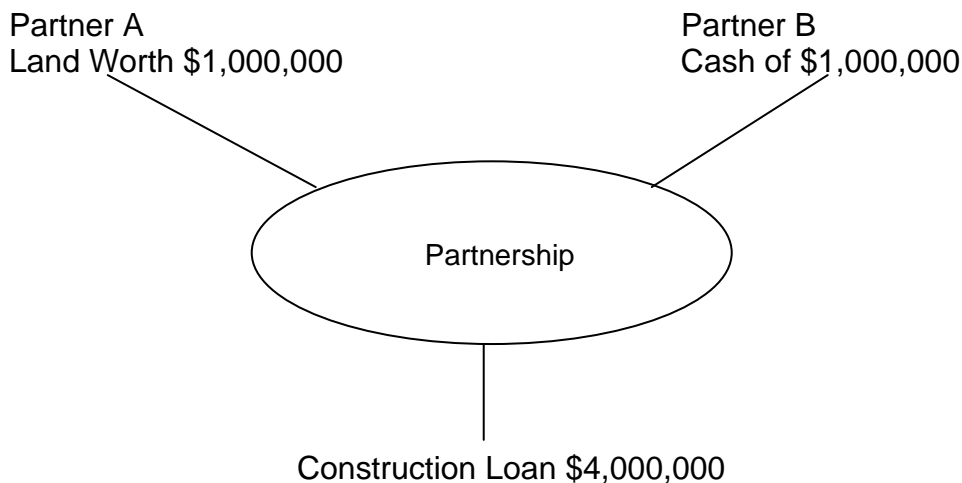
(i) The preamble to the final regulations states:

"The presumptions are intended to establish which party has the burden of going forward in litigation. In addition, the regulations require that the party against whom the presumption runs must clearly establish that the transaction is or is not a disguised sale as the case may be. Thus, a mere preponderance of evidence (the standard of persuasion that would apply in the absence of the clearly establish requirement) will not suffice."

(ii) As such, the party, including the Service if it is the party attempting to rebut a presumption, needs to prove by more than a preponderance of the evidence in litigation that the presumption should not apply.

Example:

Facts:

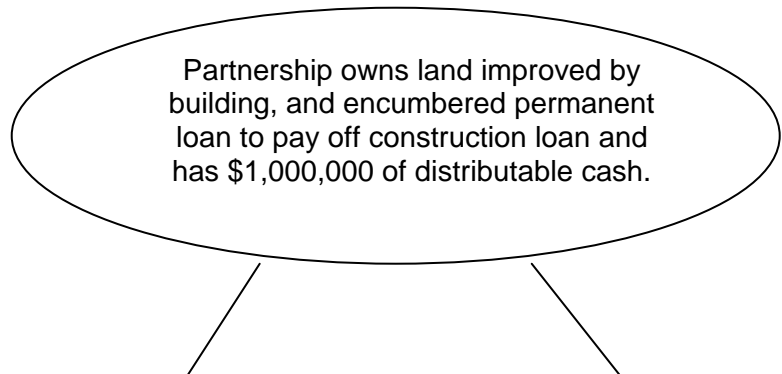


Costs to construct Building \$5,000,000 to be funded by \$1,000,000 contributed by Partner B and Construction Loan.

(iii) The partnership agreement provides that after completion of improvements on the property, a permanent loan will be secured and the proceeds of the permanent loan will be utilized in the following order and priority: (i) to pay off the construction loan; and (ii) the rest will be distributed to Partner A.

(iv) 2 Years Later

- (a) Building completed and a permanent loan secured. Construction loan paid off and \$1,000,000 funded to Partner A.



\$4,000,000 to pay
Construction Loan

\$1,000,000 distributed
to Partner A

- (b) Fact Pattern One: The amount of the Permanent Loan will be dependent upon the ability of the partnership to lease the building.

Q: *Is the \$1,000,000 distributed to Partner A a disguised sale?*

A: NO

WHY: Apply factors of Treasury Regulations § 1.707-3(b)(1).

- i) \$1,000,000 would not have been made but for the contribution of the land to the partnership;
- ii) Partnership agreement provides that Partner A has a legally enforceable right to receive a distribution; and
- iii) Since the amount of the Permanent Loan (and in connection therewith obtaining enough proceeds to pay off the construction loan and have surplus proceeds to distribute to Partner A) is dependent upon the

appraised value of the property after the construction and lease up of the building, Partner A bears entrepreneurial risk.

- (c) Fact Pattern Two: The partnership secures a building commitment from a permanent lender to fund a \$5,000,000 permanent loan without regard to the appraisal of the proper or lease up of the building.

Q: *Is the \$1,000,000 distributed to Partner A a disguised sale?*

A: YES.

WHY: At the time Partner A contributes the property to the partnership, the distribution of \$1,000,000 to Partner A is not dependent on entrepreneurial risk at the time the property was contributed. So, the fact that the distribution take place two years apart is immaterial.

3. Disclosure Requirement

- a. If an unfavorable presumption under the two-year rule applies and the partner does not treat the transaction as a sale for tax purposes (and no other exception exists) the partner must disclose such treatment on his tax return for the year of the transfer. Treas. Reg. §§ 1.707-3(c)(2), 1.707-8.
- (i) Disclosure is to be made on a completed Form 8275 or on a statement attached to the return that includes a caption identifying the statement as a disclosure under Section 707, an identification of the item or items with respect to which disclosure is made, the amount of each item, and the facts affecting the potential tax treatment of the item or items under Section 707. Treas. Reg. § 1.707-8(b).
- (ii) The preamble to the regulations states that “[m]eeting the disclosure requirements of these final regulations does not necessarily satisfy the disclosure requirements of Section 6662 ... and the proposed regulations thereunder (regarding the penalty for underpayment of tax)”
- b. The partnership, as opposed to the partner(s), may make the disclosure if more than one partner transfers property to the partnership. Treas. Reg. § 1.707-8(c).
- c. No penalty is expressly provided for due to the failure to make the disclosure.

C. What Happens If the Transaction is Treated as a Disguised Sale?

1. General Rules

a. Straight Sale.

A sale between the contributing partner and the partnership. Treas. Reg. § 1.707-3(a)(1). However, if it is determined that no partnership exists, the transferor is treated as selling the property to the person or persons that acquired ownership of the property for tax purposes. Treas. Reg. § 1.707-3(a)(3).

b. Part Sale, Part Contribution.

(i) If a disguised sale is deemed to occur but the value of the consideration distributed to a partner is less than the value of the property contributed to the partnership, the sums will be prorated and the transaction will be treated as a sale in part and a contribution in part. Treas. Reg. § 1.707-3(f), Ex. 1.

(ii) The regulations do not appear to restrict the partner's ability to designate property as being sold or contributed. As such, careful planning may result in the ability to avoid gain if the partner "sells" high basis property to the partnership and "contributes" low basis property.

Example:

- 1) A owns two properties (Property One and Property Two)
- 2) Property One has \$1,000 value and 0 basis
- 3) Property Two has \$500 value and \$500 basis

Step One:

A contributes Property One to partnership

Step Two:

A sells Property Two to partnership for \$500

Net Result:

Property One and Property Two in partnership.
Averaging no gain.¹

- c. Installment Sale. Several cases and rulings in the installment sale area conclude that where a taxpayer sells multiple assets in a deferred payment sale, the seller can allocate the cash down payment to assets that do not qualify for installment reporting (such as inventory) and the note to assets that do.²

There is zone authority that suggests that "cherry picking" in an installment sale contract will be disallowed.³

2. Treatment of a Disguised Sale

When a partner contributes property to a partnership and at a later date receives a distribution that is characterized as a disguised sale. The partnership is treated as issuing to the partner on the date of the presumed sale (in other words, when the property is delivered) a current and enforceable obligation to transfer cash or other consideration to the partner. Treas. Reg. § 1.707-3(a)(2). In such a case, the disguised sale may constitute an installment sale; and the transaction will be subject to imputed interest if the obligation to sell was placed more than six (6) months after the deemed sale. Treas. Reg. § 1.707-3(b). This can result in unexpected consequences to the partners' capital accounts.

D. Payments From a Partnership to a Partner That Are Not Disguised Sales.

The regulations contain four (4) major exceptions to the presumption of disguised sale treatment that would otherwise fall within the two-year presumptions.

¹ The proposed revisions to Section 707 suggested the ability to aggregate the transactions to avoid this result; however, this section was not revised in the Final Regulations.

² See Collins v. Comm'r, 48 T.C. 45 (1967), acq. 1967-2 C.B. 2; Monaghan v. Comm'r, 40 T.C. 680 (1963); Rev. Rul. 68-13, 1968-1 C.B. 195; Rev. Rul. 57-434, 1957-2 C.B. 300. Arguably, if the taxpayer can designate which property is sold for cash and which for a note for purposes of section 453, the taxpayer should be able to designate which property is transferred to a partnership in exchange for cash and which is transferred in exchange for a partnership interest. See also Brown v. Comm'r, 27 T.C. 27 (1956), acq. 1957-2 C.B. 4 (in an incorporation of a partnership, designation of property transferred for stock versus property transferred for an installment obligation was respected).

³ See, e.g., Rev. Rul. 68-55 (in a transfer of multiple properties for stock and cash, the transferor must allocate stock and cash to each property based on relative fair market values).

1. Guaranteed Payments⁴

- a. A "reasonable" guaranteed payment for capital will not be treated as disguised sale "facts and circumstances" dictate otherwise. Treas. Reg. § 1.707-4(a)(1)(i) and (ii). A "guaranteed payment for capital" is defined as "... 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." Section 707(c). 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." Treas. Reg. § 1.707- 4(a)(1)(i).
- b. The test of "reasonableness" is a multiple part test.
- (i) First, if the sum of any guaranteed payment for capital and preferred return for any year cannot exceed the amount determined by multiplying the partner's unreturned capital at the beginning of the year or the partner's weighted average capital balance for the year by the safe harbor interest rate for that year. Treas. Reg. § 1.707-4(a)(3)(ii).
- (ii) The safe harbor interest rate for a partnership's taxable year a reasonable sum must be less than 150 percent of the highest applicable federal rate in effect at the time that the right to the guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners ; and
- (iii) To determine a partner's unreturned capital, determine 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 reasonable preferred returns and operating cash flow distributions).
- c. If a guaranteed payment for capital is presumed to not be reasonable, it will be "presumed" not to be a guaranteed payment for capital (and as such a disguised sale) unless the "facts and circumstances" clearly establish otherwise. Treas. Reg. § 1.707-4(a)(1)(iii).

⁴ The guaranteed payment addressed herein only applies to the contribution of property or capital to the partnership and not to services.

- d. If a payment to a partner is characterized by the parties as a guaranteed payment for capital but is not respected as such, the payment is subject to the general disguised sale rules, including the presumptions for transfers made less than or more than two years apart. Treas. Reg. § 1.707-4(a)(1)(iii).

2. Preferred Return

- a. A "preferred return" is defined as 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." Treas. Reg. § 1.707-4(a)(2). Prepared returns will not be considered part of a sale of property unless the facts and circumstances clearly establish otherwise.

3. Cash Flow Distributions

- a. A distribution of operating "cash flow" from a partnership to a partner is presumed not to be part of a sale of property contributed to the partnership, unless the facts and circumstances clearly establish otherwise. Treas. Reg. § 1.707-4(b)(1).
- b. In order for a distribution to be deemed an operating cash flow distribution (1) such distributions are not presumed to be guaranteed payments for capital, (2) such distributions are not preferred returns, (3) such distributions are not characterized by the parties as distributions to the recipient partner acting in a capacity other than as a partner, and (4) such distributions do not exceed the product of (a) the net cash flow of the partnership from operations for the year multiplied by (b) the lesser of the partner's percentage interest in overall partnership profits for that year or over the life of the partnership. Treas. Reg. § 1.707-4(b)(2)(i).
- c. The regulations define a partnership's net cash flow from operations for a taxable year as 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 noncash charges deducted in determining such taxable income and decreased by - (A) Principal payments made on any partnership indebtedness; (B) Property replacement or contingency reserves actually established by the partnership; (C) Capital expenditures when made from other than reserves or from borrowings the proceeds of which are not included in operating cash flow; and (D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss." Treas. Reg. § 1.707-4(b)(2)(i).

4. Pre-formation Expenditures

- a. Distributions made to reimburse partners for certain capital expenditures are not disguised sale proceeds. Treas. Reg. § 1.707-4(d).
- b. To qualify for reimbursement under this rule, the capital expenditure must have been incurred within two years before the property contribution to the partnership and must be for partnership organization and syndication costs described in section 709 or for property contributed to the partnership by the partner.⁵

E. Assumption of Liabilities

1. Recourse / Non-Recourse Liabilities

A partnership liability is a non-recourse liability to the extent, but only to the extent, that no partner bears the economic risk of loss for the liability. Treas. Reg. § 1.752-1(a)(2). A party's share of non-recourse liability is determined by applying the "excess non-recourse liability" percentage from Treas. Reg. §

2. Qualified Liabilities

- a. There are four categories of liabilities that are "qualified liabilities"; provided, however, that in any event even if a recourse liability that is characterized as a qualified liability, the liability may not exceed the fair market value of the contributed property net of other liabilities. The four categories of qualified liabilities are:
 - (i) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property, provided the liability encumbered the property throughout that two-year period. Treas. Reg. § 1.707-5(a)(6)(i)(A).
 - (ii) A liability that was not incurred in anticipation of the transfer of the property to the partnership but was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership, provided the liability has encumbered the property since it

⁵ Reimbursement for expenditures in this last category may not exceed 20 percent of the value of the contributed property at the time of the contribution, unless the value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution.

was incurred. Treas. Reg. § 1.707-5(a)(6)(i)(B). In such an event, the liability will be presumed to be incurred in anticipation of the transfer unless the “facts and circumstances” clearly establish that the liability was not incurred in anticipation of the transfer. Treas. Reg. § 1.707-5(a)(7)(i). As such, the burden is generally on the taxpayer to establish that the debt was not waived in anticipation of the contribution; however, the presumption does not apply to certain liabilities relating to acquisition or improvement and liabilities incurred in the ordinary course of business if substantially all assets used in the activity are transferred to the partnership).⁶

- (iii) A liability is allocable (under the interest tracing rules of Treas. Reg. § 1.163-8T) to capital expenditures with respect to the transferred property. Treas. Reg. § 1.707-5(a)(6)(i)(C).
- (iv) A liability that was incurred in the ordinary course of the trade or business in which the property contributed to the partnership was used or held, but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business. Treas. Reg. § 1.707-5(a)(6)(i)(D).

3. Treatment of Transferees

- a. The regulations do not contain any explicit provisions regarding the application of the disguised sale rules to the transferee of a partnership interest. Treas. Reg. § 1.707-7.

- (i) Facts.⁷

- 1) S is subsidiary of P
- 2) S owns real property encumbered by non-recourse liability
- 3) S incurs a capital expenditure
- 4) The next day, S liquidates and the real property is conveyed to P subject to the liability

⁶ If a partner treats a liability incurred within the two-year period as a qualified liability, the treatment must be disclosed in accordance with Treas. Reg. § 1.707-8. Treas. Reg. § 1.707-5(a)(7)(ii).

⁷ From Revenue Ruling 2000-44.

- 5) One year later, P contributes property to a new partnership entitled PRS in exchange for an interest in PRS
- 6) PRS reimburses P for the capital expenditure
- 7) The fair market value of the real property exceed the liability amount

(ii) Questions:

- 1) *Is the reimbursement of the capital expenditures a disguised sale?*
- 2) *Is the non-recourse liability a qualified liability?*

(iii) Conclusions:

- 1) P succeeds to S status so reimbursement for capital expenditures do not give rise to a disguised sale between P and PRS = NO disguised sale
- 2) Since the non-recourse liability was incurred more than 2 years ago, it is a qualified liability = NO disguised sale

4. Determination of Consideration for the Assumption of a Liability

a. If an assumption of liabilities is deemed to be a disguised sale, the selling partner will be deemed to have received the lesser of (1) the amount of consideration that the partnership would be treated as transferring to the partner had the liability constituted a nonqualified liability, or (2) the amount obtained by multiplying the amount of the qualified liability by the partner's "net equity percentage" with respect to the contributed property. Treas. Reg. § 1.707-5(a)(5)(i).

(i) For purposes of determining a partner's "net equity percentage" with respect to an item of contributed property, a determination is made of the percentage determined by dividing:

(a) the aggregate transfers of money or other consideration actually or deemed to be received by the partner from the partnership (other than any transfer attributable to the qualified liability) that are treated as proceeds realized from the sale of the transferred property, by

- (b) the excess of the fair market value of the contributed property at the time it is transferred to the partnership over any qualified liability encumbering the property (or, in the case of any qualified liability that is described in categories three and four above, that is properly allocable to the property). Treas. Reg. § 1.707-5(a)(5)(ii).

5. Debt-Financed Distributions

- a. If a partner contributes property to a partnership and the partnership incurs a liability all or a portion of the proceeds of which are allocable under Treas. Reg. § 1.163-8T to a distribution of money or other consideration to the partner made within 90 days of incurring the liability, the distribution of money or other consideration to the partner is taken into account as disguised sale proceeds only to the extent that the amount of money or the fair market value of the other consideration distributed exceeds that partner's "allocable share" of the partnership liability. Treas. Reg. § 1.707-5(b)(1),
- b. A partner's "allocable share of the partnership liability" equals the amount obtained by multiplying the partner's share of the liability (determined in the same manner as the sharing of non-qualified liabilities) by the fraction obtained by dividing the portion of the liability that is allocable under Treas. Reg. § 1.163-8T to the money or other property transferred to the partner by the total amount of the liability. Treas. Reg. § 1.707-5(b)(2).
- c. Special rules are provided for debt-financed transfers to more than one partner pursuant to a plan, subsequent reductions in a partner's share of liabilities, and refinancings. Essentially, all of the liabilities incurred pursuant to the plan are treated as one liability. Treas. Reg. §§ 1.707-5(a)(4), 1.707-5(a)(3), 1.707-5(c).

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