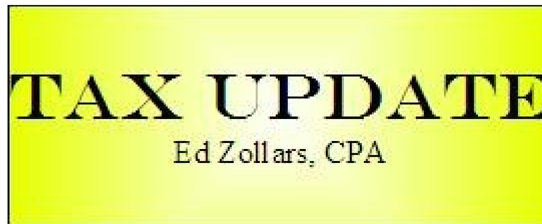

Literally Too Good to Be True-IRS Memorandum on Partnership Transaction
Podcast of January 20, 2007

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Attempting to Cash in a Partnership Interest for a New Home

Recently the IRS issued a legal memorandum where it attacked a transaction where a taxpayer attempted to use a transaction that the taxpayer claimed literally complied with §§ 731 and 732 to avoid tax on using his soon to be redeemed partnership interest to obtain a house that the taxpayer wished to obtain, and to do so at no tax cost. The memorandum (ILM 200650014) gives an insight to what methods the IRS might employ to recast transactions they believe utilize the IRC to get a "too good to be true" result. Such transactions are especially prevalent in transactions that attempt to make use of various partnership basis rules to avoid what would otherwise be a taxable transaction.

Distributions from a Partnership

To understand the transaction, it's important first to review the provisions in the IRC that the transaction purported to make use of. Partnerships have the advantage of being the

entity that generally offers the most liberal rules to transfer property tax free both into and out of the entity. On formation, §721 that applies to transfers to a partnership does not have a "control" requirement such as the one we see in §351 and it's even possible, depending on net debt deemed assumed by the incoming partner, to transfer assets and debt to a partnership tax free even if the debt on the property exceeds the taxpayers' basis in the property.

But in the transaction in question we are concerned not with getting assets into the partnership, but rather getting assets out of the partnership. In a corporation such distributions are problematical—if the asset is appreciated, §311(b) requires that the corporation recognize the gain. If the corporation is a C corporation, that distribution also becomes a taxable dividend. If the corporation is liquidating, the corporation still will recognize that gain, but the shareholder then treats the value received as payment for his/her stock and computes the gain or loss. Even if the corporation is an S corporation, that first gain on the appreciation of the asset is still triggered.

The default rule for partnerships is far more liberal. While subject to a number of "special case rules" that work to avoid what would generally be disguised sales of appreciated assets between partners, in general a distribution of property from a partnership is not a taxable event. §731 governs these transactions for both the individual partner and the partnership.

For the partner, we look at §731(a) for the general rule. That provision provides:

> (a) Partners
>
> In the case of a distribution by a partnership to a partner--
>
> (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and
>
> (2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of--
>
> (A) any money distributed, and
>
> (B) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d).
>
> Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

As you will note, this treatment is much more friendly than the treatment a shareholder of a C corporation gets, and even is more liberal than an S corporation shareholder gets—an S corporation shareholder's gain is not measured solely based on the cash the shareholder gets, but rather also considers the value of property received if the total consideration received exceeds the shareholder's basis.

The partnership itself also fares much better than a corporation. The partnership's treatment is governed by §731(b) which holds

> (b) Partnerships
>
> No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.

In a partnership, the negative consequence only really affects the basis of the property received. That treatment is governed by §732. The treatment is slightly different depending on whether we have a regular distribution or a liquidating distribution:

> (a) Partners
>
> In the case of a distribution by a partnership to a partner--
>
> (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and
>
> (2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of--
>
> (A) any money distributed, and
>
> (B) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d).
>
> Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

Note that even if a partner has no remaining basis in his/her partnership interest, there still will be no gain recognized on the distribution of any amount of property. So the partner could receive property worth millions in exchange for his interest from the partnership in liquidation and even though the taxpayer had no remaining basis not recognize current income.

Rather in that case the property worth millions would take on the remaining basis in the

partnership interest, or zero. Thus the tax would be deferred until the taxpayer eventually sold that piece of property.

In a corporation, that same taxpayer would have paid tax when the property came out to him/her in liquidation of his/her interest. If the taxpayer had a zero basis in the shares, the entire value of the property would be immediately taxable, though the taxpayer would now have basis equal to fair value of the property. Clearly, most taxpayers if given the choice would prefer to delay paying the tax and take the lower basis.

Taxpayer's Transaction

Now we consider the facts set out in ILM 200650014. The taxpayer in question was a partner in a partnership where, as often happens, the partners were bickering and a decision was made for the partnership to buy out a number of partners. The soon to be ex-partner's redemption agreement provided for the following steps to be taken in redeeming his interest

- The partner would be paid a certain amount in cash as a partial payment for his interest. In fact, that payment, when combined with the deemed distribution due to debt relief under §752(b), was greater than the remaining basis the partner had in his interest.
- The remaining amount of his interest would be paid for by receiving an asset from the partnership—one the partnership did not yet own
  - The partnership would acquire a house that the partner had chosen, acquiring the house in a single member LLC the partnership would have formed for this purpose
  - To the extent the partnership expended more for the house than the remaining amount of the purchase price of the partner's interest, the partner would obtain a new loan against the property and have the proceeds paid to the partnership
  - The agreement provided for what would happen if the taxpayer could not close on a new loan in a timely fashion in a way that essentially protected the partnership from incurring any additional costs—rather, the partner effectively took on the risk should anything go wrong

The partnership formed the LLC in question and acquired the house in Year 1. The LLC obtained its loan to purchase the house from another partner of the partnership, who was also being redeemed out. In Year 2, the taxpayer took out a mortgage on the house, repaid the LLC who then repaid the other partner. The house was then transferred to the taxpayer by grant deed.

In the taxpayer's view, the transactions had the following tax consequences:

- The taxpayer first offset the entire amount of his basis against the cash and §752(b) relief of debt, and recognized gain to the extent of the excess of that

distribution over his basis

- The taxpayer recognized no gain on the receipt of the equity in house from the partnership. Rather, the taxpayer treated this as a distribution of property from the partnership governed by §731. As such, since the house was not money, and no gain would be recognized.

In the taxpayer's view he had managed to convert his partnership interest into an interest in a house he wanted in a tax free transaction. And, if the relevant provisions are interepreted literally, the transaction certainly appear to work.

Note that while there are provisions in the law that attempt to prevent using the partnership rules to prevent "tax free exchanges" of a sort that could not meet the §1031 tests otherwise, they are aimed at taxpayers contributing appreciated property to a partnership. The provisions don't deal with this case—where the appreciated asset is the partnership interest itself. So the taxpayer seemingly has found a great hole in the scheme that would otherwise have prevented the taxpayer from exchanging his interest in a partnership tax free for an unrelated piece of real estate.

IRS Objections

However, as you may expect, the IRS's memorandum doesn't agree that it qualifies for such treatment. In fact, the IRS attorney raises three different objections to the taxpayer's tax treatment.

Theory One: The House was Not Partnership Property

The memorandum first goes back and looks at the old, original committee reports on the adoption of the 1954 Internal Revenue Code for the reasons behind the adoption of §§721 and 731. Citing both the House Ways & Means and Senate Finance Committee reports, the IRS points out that the purpose of these provisions was to allow taxpayers to move assets into and out of the partnership. The IRS notes the following line from the Senate Finance Committee report, applying the highlight shown below:

> These rules, combined with the nonrecognition of gain or loss upon contribution of property to a partnership, *will remove deterrents to property being moved in and out of partnerships as business reasons dictate*.

The IRS's issue is that this movement of the house into and out of the partnership was not dictated by business reasons. The IRS notes:

> Under the facts presented in this case, a carry-over basis is not appropriate for a unique parcel of residential property that apparently was selected by the distributee, acquired by the partnership immediately before the distribution, solely for the purpose of the distribution, and was unrelated to the partnership's business activities.

The IRS goes on to assert that, in fact, the partnership never really was the owner the property. The IRS notes that if the deal fell through, the taxpayer and not the partnership was the one who would get the net left over after the property was sold and the debt repaid—so the partnership never had the risks and rewards of ownership, rather it vested in the partner from the instant the property was acquired.

The IRS also reasons that the case is similar to the fact pattern in Revenue Ruling 55-39, where the taxpayer directed the partnership to acquire securities with his capital account. In that ruling, the IRS ruled that the segregation of those funds and investment in the selected securities amounted to a distribution to the taxpayer of the funds used to purchase the investment. In this case, the IRS argues that what we really had was a cash distribution to the partner of the amount of the remaining purchase price of his interest which was then paid to purchase the house. In that case, since the taxpayer's basis in the partnership was already exhausted, the taxpayer would pay tax on the entire amount of that deemed cash distribution

Theory Two: Partnership Anti-Abuse Rules Apply

Of course, the first theory depends on a court agreeing that the house was never partnership property. If the court does not agree with that theory, the IRS's taxation logic would fall apart as there would not be a distribution of cash. So the memorandum goes on to give arguments for alternative theories of taxation.

The first alternative theory is that this transaction is "caught" by the partnership anti-abuse rules of Reg. §1.702-2. Those regulations hold that if an activity violates those rules, the IRS can recast the transaction under Reg. §1.702-2(b) to be viewed in a "more appropriate" form.

Reg. §1.702-2(a) provides the "intent" test that transactions for partnerships need to overcome to be respected. That provision reads:

> (a) Intent of subchapter K.
>
> Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements --
>
> (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.
>
> (2) The form of each partnership transaction must be respected under substance over form principles.
>
> (3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions

> between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, PROPER REFLECTION OF INCOME). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. See, for example, paragraph (d) EXAMPLE 6 of this section (relating to the value-equals-basis rule in section 1.704-1(b)(2)(iii)(c)), paragraph (d) EXAMPLE 9 of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) EXAMPLES 10 AND 11 of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, sections 1.704-3(e)(1) and 1.752-2(e)(4) (providing certain de minimis exceptions).

If a transaction violates Reg. §1.702-2(a), Reg. §1.702-2(b) holds in part:

> Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, *the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K*, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.

The memorandum looks at this transaction and concludes it would be trapped by Reg. §1.702-2, noting:

> To liquidate Taxpayer's interest in Partnership, Partnership made a purported distribution to Taxpayer of the fair market value of the State Y house (in addition to $g debt relief and $h total cash payments) to Taxpayer for the value of Taxpayer's interests in Partnership. Because this exceeded Taxpayer's basis in Partnership, Taxpayer would have had to recognize an additional $a of income or gain if paid directly to Taxpayer. *By attempting to characterize the distribution of the fair market value of the State Y house as a distribution of property other than money, Taxpayer and Partnership used the rules of subchapter K inappropriately in a manner that attempted to eliminate $a of income or gain with respect to Taxpayer.* (emphasis added)
>
> We conclude that the transaction should be recast in accordance with the antiabuse rules of § 1.701-2 as a distribution of $a in cash to Taxpayer, which

> Taxpayer then used, in addition to funds provided directly (albeit temporarily) by B, to acquire the State Y house.

Thus, again the IRS gets back to treating this as a distribution of cash to the taxpayer, which triggers gain recognition, though now by using the IRS's discretionary power under Reg. §1.701-2.

Theory Three: Step Transaction Doctrine

Of course, there's always the possibility that a judge might decide the transaction did not violate the "spirit" of Subchapter K, in which case Reg. §1.701-2(b) couldn't be invoked. So the IRS includes one more theory to try and derail this transaction—the tried and true step transaction and economic substance theories.

The memorandum cites a description of the step transaction doctrine from the case of *Smith v. Commissioner*, 78 T.C. 350, 389 (1982), aff'd without op., 820 F.3d 1220 (4th Cir. 1987), which held:

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. See *Gregory v. Helvering*, 293 U.S. 465 (1935).

The memorandum outlines three tests for application of the step transaction doctrine. Per the memorandum:

> There are three alternative tests for deciding whether the step transaction doctrine applies in a particular situation, namely: (1) if at the time the first step was entered into, there was a binding commitment to undertake the later step(s) ("binding commitment test"), (2) if separate steps constitute prearranged parts of a single transaction intended to reach an end result ("end result test"), or (3) if separate steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the series of steps ("interdependence test"). See *Associated Wholesale Grocers, Inc. v. Comm'r*, 927 F.2d 1517 (10th Cir. 1991).

The memorandum then argues that this transaction meets both the first and second tests—there was a binding commitment from the start to complete the steps, and the transactions were a prearranged series of steps to get the house to the exiting partner in exchange for his partnership interest.

The IRS also argues there was no economic substance to the partnership's participation in this transaction. The IRS notes:

> Objectively, Partnership's purchase of the State Y house and immediate distribution to Taxpayer had no practical economic effects aside from the avoidance of gain recognition. The acquisition of the State Y house was structured to avoid any potential gain or loss by Partnership on the transaction. Taxpayer was apparently entitled to $a of value from Partnership and received $a of value. The use of a residential property acquired solely for the purpose of avoiding gain recognition on that $a of value had no objective economic effect.
>
> Subjectively, Partnership and Taxpayer clearly had no intent to profit economically from the transaction. It is evident from the terms of the redemption agreement that the State Y house was to be distributed by LLC.to Taxpayer immediately upon Taxpayer obtaining a loan (within 60 days) to fund the purchase. In addition, LLC would be reimbursed all costs and expenses associated with the purchase of the State Y house. If Taxpayer could not obtain the necessary loan within 60 days, LLC would immediately sell the State Y house. It is difficult to conclude an intent to profit from the purchase and sale of a house within a brief 60 day period. Clearly, the sole purpose of the transaction was to obtain tax benefits that would not be available otherwise.

Conclusion

Due to their flexibility, partnerships have been a favorite area for aggressive tax planning strategies, leading to the anti-abuse regulations found in Reg. §1.701-2 and quite a bit of litigation in the economic substance and step-transaction arena, as taxpayers attempt to use literal compliance with the language of the law and the IRS attempts to argue that the benefits being obtained were never intended.

This particular transaction is interesting because, unlike the tax shelters of the late part of the last decade and first part of this one, this situation involved an existing partnership and a transaction simply designed to liquidate it. So we don't have a partnership formed and marketed as a shelter, but rather an attempt to structure a transaction that was going to take place anyway in a tax favored manner. It also is instructive in noting that the IRS is now "sensitive" to the use of partnerships in such a manner and the objections brought to bear.