4000 CONTRIBUTIONS TO PARTNERSHIPS

4010 GENERAL

Contributions to a partnership are common and therefore the determination of the tax ramification is important from a compliance standpoint.

Internal Revenue Code (IRC) § 721 states that the contributions of property to the partnership in exchange for a partnership interest generally is a nontaxable transaction to the contributing partner and to the partnership. This applies to both contributions at the time of formation of the partnership and subsequent contributions.

There are several exceptions to the general rule. Gain or loss is recognized when:

- A partner receives a capital interest in a partnership for services (See PTM 4330);
- A partner receives a profits interest in a partnership for services (See PTM 4310);
- A partner acts in other than his capacity as a partner, in a transaction with the partnership (See PTM 4410);
- Encumbered property is contributed to a partnership (See PTM 4120);
- Property is transferred to a partnership which would be treated as an investment company if it were a corporation (See PTM 4540);
- A partner contributes property and that property is distributed to another partner or there is a distribution of other property to the contributing partner. This transaction may be treated as a sale or exchange (See PTM 4500);

- A partner contributes property and receives a distribution of cash or other property (See PTM 4420).

The partnership's basis in the contributed property must be computed. (See PTM 4600)

4020 CALIFORNIA CONFORMITY

California Revenue and Taxation Code (CR&TC) § 17851 generally conforms California law to IRC § 721 through § 724 that makes contributions of property to partnerships tax free. There are exceptions to the general conformity rules that will be discussed at length in the corresponding sections.

4030 CONTRIBUTIONS OF CASH

The basis of a partner's interest in a partnership acquired in exchange for a contribution solely of cash is the amount of cash contributed to the partnership. [IRC § 722, CR&TC § 17851] (See PTM 5030)

4040 DEFINITION OF PROPERTY

Although IRC § 721 provides that a contribution of property in exchange for a partnership interest may be tax free, the Code does not define what constitutes "property" as it relates to this section. The term, however, has been broadly construed to include such things as money, installment obligations, goodwill, and even accounts receivable of a cash method taxpayer.[16]
It does not however encompass services. (See PTM 4300) The regulations under IRC § 721 provide that property includes an installment obligation.

The following have been held to be "property" contributed to a partnership:

- Rights and assets created by personal effort of a partner. [*United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964), geological maps created by contributing partner were held to be property]; [*Stafford v. United States*, (11th Cir. 1984) 727 F.2d 1043, a letter of intent (of questionable enforceability) between a developer and an insurance company was held to be property.]
- A contractual right to participate in another partnership [*Dillon v. United States*, 84-2 USTC P 9921];

[16] See, e.g., Stafford v. United States, (11th Cir. 1984) 727 F.2d 1043, 1049–1052, construing "property" for purposes of IRC § 721 as analogous to "property" for purposes of IRC § 351.

- Limited partnership interests in a partnership which holds unrealized receivables [Revenue Ruling (Rev. Ruling) 84-115, 1984-2 CB 118];
- Cash, third party demand notes, and third party mortgage. [Private Letter Ruling 8117210]
- Technical know-how, goodwill and accounts receivable generated by the performance of services on behalf of a third party. [Rev. Rul. 64-56, 1964-1 CB 133]; [Rev. Rul. 79-288, 1979-2 CB 139]; [*Roberts Co.,* 5 TC 1 (1945)]

In addition, Treasury Regulation (Treas. Reg.) § 1.721-1(a) also differentiates between a contribution of property and a contribution of the right to use property, implying that IRC § 721 does not apply to the latter.

For further discussions of what constitutes property, see McKee, Nelson and Whitmire, Federal Taxation of Partnerships and Partners, 4th Edition, ¶ 4.02[1]; Willis, Postlewaite & Alexander: Partnership Taxation, 8th Edition, ¶ 4.02.

4100 CONTRIBUTION OF PROPERTY

4110 Unencumbered Property – General

Generally, the contribution of unencumbered property is tax free to the partnership and the contributing partner. [IRC § 721(a), CR&TC § 17851]

The partnership's basis in the contributed property (inside basis) is equal to the adjusted basis of the property to the contributing partner at the time of contribution. The partnership is also entitled to tack the partners' holding periods to its own. (IRC § 1223(2); Treas. Reg. § 1.723-1.) If the contributing partner recognized gain under IRC § 721(b), the partnership would increase its inside basis in the property by the same amount of gain recognized by the contributing partner. [IRC § 723]

Partners may recognize gain on a transfer of appreciated property to a partnership that would be treated as an "investment company" (within the meaning of §351) if the partnership were incorporated. [IRC § 721(b)] (See PTM 4540)

The recognition of gain on a transfer of appreciated property to a partnership investment company results in a "stepped up" basis for the contributed property. [IRC § 723]

4120 Contribution of Encumbered Property

The contribution of encumbered property to a partnership may result in a gain to the contributing partner. [IRC §§ 752(a), 752(b), 731(a)(1), 733; Treas. Reg. § 1.722-1]

Non-recognition treatment under IRC § 721 may not apply if the contributed property is encumbered with debt. The contributing partner may recognize gain. The partnership's assumption of the liability is treated as a distribution of cash to the contributing partner and the contributing partner will also be treated as

contributing cash to the extent the partner is allocated a share of the partnership's liabilities, including the liability encumbering the contributed property. Both of these adjustments are deemed to occur simultaneously and only the net change is taken into account. If the contributing partner's net decrease in liabilities is greater than partner's total basis in all the assets contributed, the contribution will result in a gain [IRC §§ 752(a) and (b), 731(a)(1), 733; Treas. Reg. § 1.722-1]

When a partner contributes encumbered property to a partnership, there is a shifting of the responsibility for payment from contributing partner to the partnership which now owns the property. This liability shifting has two effects on a partner's outside basis in her partnership interest:

1. Each partner is considered to make a cash contribution (deemed contribution) equal to her share of the increase in partnership liabilities. [IRC §§ 722 and 752(a); Treas. Reg. §§ 1.721-1, 1.752-1.]
2. A contributing partner is considered to receive a cash distribution (deemed distribution) equal to the entire liability assumed by the partnership, which may require the contributing partner to recognize gain. [IRC §§ 705(a)(2), 731(a)(1), 733, 752(b); Treas. Reg. § 1.722-1; 1.752-1]

For a discussion on Sharing of Liabilities, see PTM 5500.

4121 Property Encumbered with a Recourse Liability

A partnership liability is a recourse liability to the extent that any partner or related person bears the "economic risk of loss" for that liability. [Treas. Reg. § 1.752-1(a)(1)] (See PTM 5490)

Recourse liabilities are allocated to those partners who bear the economic risk of loss associated with those liabilities. A partner bears the economic risk of loss for a partnership recourse liability to the extent the partner would be obligated to make a payment to the creditor if there was a constructive liquidation of the partnership in which the recourse liability becomes due and all assets of the partnership became worthless and were sold for zero consideration other than relief from nonrecourse liabilities secured by partnership property, and gain and loss was allocated, to the partners. [Treas. Reg. § 1.752-2(a)] (See PTM 5500 and PTM 5520)

If the partnership assumes a liability encumbering contributed property, the portion of the liability allocated to other partners under IRC § 752 is treated as a cash distribution from the partnership to the contributing partner. [IRC § 752(b)] (See PTM 5500 and PTM 5200) In combination with IRC § 733, this has the

effect of reducing the partner's outside basis (but not below zero) by the amount of cash distribution.

If the contribution of property affects the partners' shares of partnership profits and losses, then their shares of the partnership liability may also change under IRC § 752. For example, if a partner's share of profits and losses decreases, then the partner is treated as receiving a cash distribution from the partnership subject to the distribution rules. (See PTM 5200)

The contributing partner's tax basis in his partnership interest (outside basis) has several adjustments when property encumbered by a recourse liability is contributed. They are as follows:

- The contributing partner's outside basis is increased by his adjusted basis in the contributed property, any money contributed, and the portion of any pre-existing partnership liabilities allocated to him (deemed cash contribution). [IRC §§ 722, 752(a)]
- The contributing partner's outside basis is decreased by (but not below zero) by the amount of his former liabilities that are allocated to the other partners as a result of the partnership's assumption of the liabilities (deemed cash distribution). [IRC §§ 752(b), 733]
- If the portion of the contributing partner's liabilities allocated to other partners is in excess of his outside basis, the excess is a deemed cash distribution and is taxable gain to the contributing partner. [IRC §§ 731(a)(1), 741; Treas. Reg. § 1.731-1(a)]

The non-contributing partners' tax bases in their partnership interest (outside basis) are adjusted as follows:

- Increased by his share of the contributing partner's liabilities that have been assumed by the partnership (deemed cash contribution). [IRC § 752(a)]
- Decreased by the portion of his share of pre-existing partnership liabilities that are reallocated to the contributing partner (deemed cash distribution). [IRC §§ 733, 752(b)]
- If the deemed distribution resulting from the reduction of liabilities allocated to the non-contributing partner is greater than his adjusted basis in his partnership interest, taking into account all of the other adjustments, the excess is taxable to the non-contributing partner. [IRC §§ 731(a)(1), 752(b); Treas. Reg. § 1.752-1(f)]

Example:

A acquires a 1/3 interest in AB, a general partnership, by contributing land. At the time of the contribution, the land has a fair market value of $20,000, an

adjusted basis to A of $10,000, and is encumbered by a recourse mortgage of $6,000 that is assumed by the partnership. B contributes $28,000 to the partnership for the remaining 2/3 interests in AB. The partnership assumes the entire liability on the contributed property.

A's individual liability is viewed as first decreasing by $6,000 and then increasing by $2,000 ($6,000 x 1/3). Only the net decrease is taken into account. [Treas. Reg. § 1.752-1(f)] B is considered as incurring a $4,000 increase in his share of partnership liabilities ($6,000 x 2/3).

A and B's initial bases are computed as follows:

	A's basis	B's Basis
Contribution	*$10,000*	*$28,000*
Partnership's Assumption of Liability	*(6,000)*	*0*
Liability Share	*2,000*	*4,000*
Basis in AB	*$6,000*	*$32,000*

The partnership's basis in the property is $10,000, which is the carryover basis.

If A's basis in the land had been only $3,000, the deemed cash distribution of $4,000 would have exceeded A's basis by $1,000, resulting in a $1,000 gain and zero outside basis. [IRC §§ 731(a) and 733] However, A is provided with multiple possible sharing arrangements in order to avoid this result if the liability encumbering the property is nonrecourse. [Treas. Reg. § 1.752-3(a)(3)]

4122 Property Encumbered with a Nonrecourse Liability

A partnership liability is a nonrecourse liability if no partner or related person bears the economic risk of loss for the liability. [Treas. Reg. § 1.752-1(a)(2)] (See PTM 5491 and PTM 5500)

Generally, a partner contributing an asset encumbered by a nonrecourse liability will not have a deemed distribution under IRC § 752(b) that exceeds his basis in his partnership interest.

Treas. Reg. § 1.752-3(a) allocates the nonrecourse liabilities of a partnership under three separate tiers. Each partner's share of partnership nonrecourse liabilities is the sum of its interest in these tiers:

1. Nonrecourse liabilities of the partnership are allocated first to each partner to the extent of his share of "partnership minimum gain".

"Partnership minimum gain" is defined by Treas. Reg. § 1.704-2 and a "partner's share of minimum gain" is defined by Treas. Reg. § 1.704-2(g)(1). Partnership minimum gain is the excess of partnership nonrecourse liabilities over the § 704(b) "book" value of the partnership assets they encumber. [Treas. Reg. § 1.704-2(d)(3).] Generally, there is no minimum gain created at the time of contribution when an asset is contributed to a partnership since the value of the contributed property is usually greater than the liabilities associated with the property. (See McKee, Nelson & Whitmire: *Federal Taxation of Partnerships and Partners*, Fouth Edition, ¶8.03[1])

2. Nonrecourse liabilities are next allocated to each partner to the extent that each partner would be allocated gain under IRC § 704(c) if the partnership sells all partnership property subject to nonrecourse liabilities for no consideration except the relief of such nonrecourse liabilities (commonly referred to as the "704(c) minimum gain"). [Allocations mandated by Treas. Reg. § 1.704-1(b)(2)(iv)(d)(3)]
3. The partner's share of excess nonrecourse liabilities of the partnership which were not allocated in 1 or 2. The general rule is that excess nonrecourse liabilities share is determined in accordance with the partner's profit percentage in the partnership. The regulation provides alternative methods for the partners to allocate excess nonrecourse liabilities.

The rationale for allocating nonrecourse liabilities in this manner is to coordinate the liability allocation rules with the income/loss allocation rules under IRC §§ 704(b) and 704(c). Liabilities whose relief would give rise to partnership income or gain would be allocated to the same partners to whom the income or gain would be allocated.

Example: Nonrecourse liability in excess of basis of contributed property: *A contributes a piece of land to a limited partnership in exchange for a 20% limited partnership interest. At the time of contribution, A's basis in the land is $40,000. The land is subject to an $80,000 nonrecourse liability and has a value of $100,000. The partnership assumes the liability and has no other liabilities. There is no partnership minimum gain amount since the book value is greater than the liability. The 704(c) minimum gain amount allocated to A is $40,000 ($80,000 liability less 40,000 adjusted basis in property). The remaining $40,000 of the nonrecourse liability is allocated among the partners using their profit sharing ratio. A is allocated $8,000 (20% x $40,000). Therefore, A's share of the partnership's liabilities is $48,000 ($40,000 + 8,000). Since the net decrease in A's share of the liability is $32,000 ($80,000 less 48,000) the deemed cash distribution is $32,000. [Treas. Reg. § 1.752-1(f)] Since the $32,000 net decrease does not exceed A's $40,000 initial basis in the partnership interest*

determined based on A's basis in the property, A recognizes no gain on the contribution and has a basis in his partnership interest of $8,000 ($40,000 initial basis less 32,000 deemed distribution).

Note: For further discussion on nonrecourse liabilities, see PTM 5700.

If the contributed property is depreciable, the § 704(c) gain is reduced over time as the property is depreciated, and the nonrecourse liabilities previously allocable to the contributing partner may become allocable (in whole or in part) to other partners.

4130 Character of Contributed Property

IRC § 724 precludes the use of partnership contributions as a vehicle for converting ordinary income property into capital gain property (and capital losses into ordinary losses). In addition, § 724(c) contains a special rule that prevents the conversion of built in capital losses into ordinary losses upon contributions of the following properties to partnerships.

- **Unrealized receivables**. A contribution of unrealized receivables will cause the partnership to realize ordinary income upon any subsequent disposition (or collection) of the receivables, regardless of how long they are held. [IRC § 724(a)]. The unrealized receivables are defined in IRC § 751(c).
- **Inventory items**. If the contributed property is an inventory item in the contributing partner's hands and is disposed of by the partnership within five years of the contribution, any gain or loss recognized by the partnership will be ordinary income or ordinary loss. [IRC § 724(b)] Inventory item is defined in IRC § 751(d) and is determined by treating any reference to the partnership as referring to the partner and by applying IRC § 1231 without regard to any holding period.
- **Capital loss property**. A contribution of property that would create a capital loss if sold by the contributing partner will produce capital loss treatment on the disposition of the property by the partnership within five years of the contribution to the extent of the built in loss at the time of contribution. [IRC § 724(c)]

Example 1 –Unrealized Receivable:
C, a cash method sole proprietor, bills a client for $10,000 for services rendered. The client has suffered financial difficulties and has not been able to pay C. C contributes the receivable to a partnership that invests in stock and bonds. At the time C contributes the receivable, it was worth $4,000. In exchange, C receives a 1/3 interest in the partnership. Six months later, the partnership

collects the full $10,000 on the receivable. The partnership must characterize the full $10,000 gain as ordinary income even though it held the receivable as a capital asset.

Example 2 –Capital Loss Property:
F, an investor in real estate, contributes a real estate investment (unimproved land) that he owned for six years to a partnership in exchange for an interest in that partnership. At the time of contribution, F's basis in the land was $70,000 and the land's value was $50,000. The partnership intends to build a strip mall on the land contributed by F, which converts the land to property used in a trade or business (IRC § 1231 property). After holding the property for another year, the partnership abandons its intent to build a strip mall on the property and sells it for $40,000, realizing a $30,000 loss. The partnership must characterize $20,000 ($70,000 basis less 50,000 value at the time of contribution) of the loss as capital. The remaining $10,000 loss is treated as IRC § 1231 loss with the potential for ordinary loss treatment by the partners.

4140 Depreciation of Contributed Property

- The general rule is that all depreciation deductions for an asset are determined by using the depreciation rules (method, life, salvage value, etc.) in effect at the time the taxpayer places that asset in service. [IRC § 168(i)(7)(A)]
- This rule applies whether legislation adopts a more or less favorable depreciation rule.
- When a partner contributes property to a partnership in a nonrecognition transaction, the contributing partner's basis and all other tax attributes inherent in the contributed property are transferred to the partnership. The partnership, in essence, steps into the shoes of the contributing partner. [IRC § 168(i)(7)(A)]
- If the property contributed to the partnership is a personal use property, the partnership shall determine its annual depreciation deductions by using the depreciation rules in effect on the date the property was converted to business use property. [Treas. Reg. § 1-168-2(j)(1)]

Example 1 –Contribution of Property used in trade or business:
A purchased an office building for $4,000,000, of which $3,150,000 is attributable to the building and $850,000 is attributable to the land. For an office building placed in service in 1988, the recovery period is 31.5 years and the straight-line method of depreciation must be used. Therefore, A's annual depreciation deductions are $100,000 for the next 31.5 years. On January 1, 1998, A contributes the building to a partnership in exchange for an interest in

that partnership. A's basis in the building was $2,150,000 ($3,150,000 less $1,000,000 depreciation deductions). A's $2,150,000 adjusted basis in the building and $850,000 basis in the land is transferred to the partnership. The partnership continues to depreciate the building $100,000 annually for the next 21.5 years.

Example 2 –Contribution of Personal Use Property

C purchased a condominium in 1986 for $275,000, which she occupied as her personal residence. On January 2, 1992, C contributed the condominium to a partnership in exchange for a partnership interest. The partnership converts the property to rental property. Residential rental property placed in service in 1992 uses a 27.5 year recovery period and the straight-line method of depreciation. The partnership is deemed to have placed the condominium in service in 1992. Starting in 1992, the partnership can depreciate the property over the next 27.5 years. The depreciation deduction is $10,000 per year.

4200 ALLOCATION OF BUILT IN GAIN OR LOSS ON CONTRIBUTED PROPERTY

If a partner contributes property to a partnership which has a basis different from its value, the contributing partner must be allocated certain items of income, gain, loss and deduction with respect to the contributed property to take into account any difference between the fair market value and the adjusted basis of the contributed property. Inherent gain or loss at the time of contribution ("built in" gain or loss) must be taken into account by the contributing partner. [IRC § 704(c)(1)(A)] Post-contribution gain or loss is allocated to the partners according to their distributive share.

Property contributed to a partnership is IRC § 704(c) property, if at the time of the contribution, the book value of the property differs from the contributing partner's adjusted tax basis in the property. The book value in this instance is equal to the fair market value at the time of contribution. [Treas. Reg. § 1.704-3(a)(3)] The "book value" is used for capital account purposes.

The purposes of these rules are to prevent partners from shifting the tax consequences with respect to unrealized gain (or loss) on property to other partners by contributing the property to a partnership. [Treas. Reg. § 1.704-3(a)(1)]

Example:
M and K form an equal partnership. M contributes land with a basis of $50,000 and a value of $40,000. K contributes $40,000 in cash. Each has an initial ***capital account*** *balance of $40,000. During the partnership's first year, the land declines in value to $30,000 and the partnership sells it for that amount. Economically, the partnership's loss of $20,000 is attributable to a $10,000 decline in value that occurred while M was the owner and a $10,000 decline in value that took place while the property was held by the partnership. Therefore, $10,000 of the loss is allocable to M under IRC § 704(c)(1)(A). The other $10,000 loss is allocable 50% to M and 50% to K. Therefore, M has a loss of $15,000 and K has a loss of $5,000 from this transaction.*

The **built in gain** on IRC § 704(c) property (defined in PTM 4200) is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. The built in gain is then reduced by decreases in the difference between the property's book value and adjusted tax basis. [Treas. Reg. § 1.704-3(a)(3)(ii)]

The **built in loss** on IRC § 704(c) property is the excess of the contributing partner's adjusted tax basis over the property's book value at the time of the contribution. The built in loss is then reduced by decreases in the differences between the property's adjusted tax basis and book value. [Treas. Reg. § 1.704-3(a)(3)(ii)]

IRC § 704(c) and Treas. Reg. § 1.704-3 apply to contributions of property governed by IRC § 721. If a transaction is classified as a sale under IRC § 707, then it is not to be considered a contribution of property to which IRC § 704(c) applies. [Treas. Reg. § 1.704-3(a)(5)]

If a contributing partner **transfers** a partnership interest, the built in gain or loss associated with that property must be allocated to the transferee partner as it would have been allocated to the transferor partner. [Treas. Reg. § 1.704-3(a)(7)]

PTM 4210 Reasonable Methods of Allocation
PTM 4211 Traditional Method
PTM 4212 Traditional Method with Curative Allocation
PTM 4213 Remedial Allocation Method
PTM 4220 Securities Partnerships
PTM 4230 Depreciation Response

4210 Reasonable Methods of Allocation

If the basis of contributed property differs from its value, IRC § 704(c)(1)(A) requires income, gain, loss and deduction with respect to the contributed property to be allocated among the partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

Allocations must be made using a reasonable method. These methods include:

- The traditional method (see PTM 4211),
- The traditional method with curative allocations (see PTM 4212),
- Remedial allocation method (see PTM 4213), and
- Other methods if reasonable.

An allocation method is not necessarily unreasonable simply because it results in lower aggregate tax liability. [Treas. Reg. § 1.704-3(a)(1)]

A partnership may use different methods of allocating gain/loss for different types of contributed property provided the partnership and partners consistently apply a single reasonable method for each item and the overall method or combination of methods is reasonable based on facts and circumstances. [Treas. Reg. § 1.704-3(a)(2)]

The allocation method used for an item must be consistently applied by both the partner and the partnership. [Treas. Reg. § 1.704-3(a)(2)]

It may be unreasonable to use one method for appreciated property and another method for depreciated property or to use the traditional method for appreciated property contributed by a partner in a high tax bracket and use the curative allocation method for appreciated property contributed by a partner in a lower tax bracket. [Treas. Reg. § 1.704-3(a)(2)]

4211 Traditional Method

The traditional method requires that when a partnership has income, gain, or loss attributable to IRC § 704(c) property (defined in PTM 4200), it must allocate to the contributing partner the built in gain or loss associated with the property to avoid shifting the tax consequences of the built in gain or loss. It permits the partnership to wait until the partnership ultimately recognizes the gain or loss. [Treas. Reg. § 1.704-3(b)(1)]

For IRC § 704(c) property that is subject to depreciation, depletion, or amortization, the allocation of deductions attributable to these items takes into account built in gain or loss on the property. For example, tax allocations to noncontributing partners of depreciation with respect to IRC § 704(c) property generally must equal book allocations to those partners. A noncontributing partner's share of the "book depreciation" would be equal to the amount of depreciation that would be allocable to him under the terms of the partnership agreement if the fair market value of the property at the time of contribution was depreciated under the income tax rules.

The ceiling rule limits the total amount of income, gain, loss or deduction that is allocated to the partners for a tax year with respect to a property to the total partnership income, gain, loss or deduction with respect to that property for the tax year. [Treas. Reg. § 1.704-3(b)(1)] For example, where the contributed property’s tax basis is significantly lower than its fair market value, there may be insufficient partnership tax deductions or eventual gain on the sale of the property to eliminate the IRC § 704(c) variation in its entirety. Adherence to the ceiling rule may require a non-contributing partner to forgo some depreciation deductions on the contributed property.

Example 1 –Allocation of built in gain:
A and B form partnership AB and agree that each will be allocated 50% of all partnership items and that AB will make the allocations under § 704(c) using the traditional method. A contributes depreciable property with an adjusted tax basis of $4,000 and a book value (fair market value) of $10,000, and B contributes $10,000 in cash. In accordance with Treas. Reg. § 1.704-3(a)(3), A has a built in gain of $6,000 which is the excess of the partnership's book value ($10,000) over A's adjusted basis in the property ($4,000) at the time of the contribution. [Treas. Reg. § 1.704-3(b)(2) Example (1)(i)]

	A		B	
	Book	Tax	Book	Tax
Initial Contribution	$10,000	$4,000	$10,000	$10,000

Example 2 –Allocation of depreciation (using the above example):
The property is depreciated using the straight-line method over a 10 year recovery period. Because the property is depreciated at an annual rate of 10%, B would be entitled to a depreciation deduction of $500 for both book and tax purposes if the adjusted basis of the property equaled its fair market value at the time of contribution. Although each partner is allocated $500 (10% of 10,000 x 50%) of book depreciation per year, the partnership is allowed a tax depreciation deduction of $400 per year (10% of 4,000). The partnership can allocate only $400 of tax depreciation under the ceiling rule and it must be allocated entirely to B.

	A		B	
	Book	Tax	Book	Tax
Initial Contribution	$10,000	$4,000	$10,000	$10,000
Depreciation	(500)	(0)	(500)	(400)
Yr 1 Ending Capital Acct	$9,500	$4,000	$9,500	$9,600

At the end of AB's first year, the book value of the property is $9,000 ($10,000 - 1,000 book depreciation) and the adjusted basis is $3,600 ($4,000 - 400 tax depreciation). A's built in gain with respect to the property decreases to $5,400 ($9,000 book value less $3,600 adjusted tax basis). Also at the end of AB's first year, A has a $9,500 book capital account and a $4,000 tax basis in her partnership interest. B has a $9,500 capital account balance and a tax basis of $9,600 in his partnership interest. [Treas. Reg. § 1.704-3(b)(2) Example (1)(ii)]

Observation: *The ceiling rule creates a disparity between B's tax and book capital accounts that will grow at the rate of $100 per year. This disparity will be locked in until B sells or retires his partnership interest. In effect, the ceiling rule causes a distortion by shifting a portion of A's built in gain to B. To "cure" the distortions created by the ceiling rule, the regulations permit partnerships to use two other allocation methods. The "traditional method with curative allocations" and the "remedial allocations method" are available to eliminate distortions between tax and book capital caused by the ceiling rule.*

Example 3 –Sale of the Property:
If AB sells the property at the beginning of AB's second year for $9,000, AB realizes a tax gain of $5,400 ($9,000 amount realized less the adjusted tax basis of $3,600). The entire $5,400 gain must be allocated to A because the property A contributed has that much built in gain remaining.

	A		B	
	Book	Tax	Book	Tax
Yr 1 Ending Capital Acct	$9,500	$4,000	$9,500	$9,600
Property Sale	$0	$5,400	$0	$0
Yr 2 Ending Capital Acct	$9,500	$9,400	$9,500	$9,600

If AB sells the property at beginning of AB's second year for $10,000, AB realizes a tax gain of $6,400 ($10,000 amount realized less $3,600, the adjusted basis) and a book gain of $1,000 ($10,000 amount realized less $9,000 book value). Only $5,400 gain must be allocated to A to account for A's built in gain. The remaining $1,000 is allocated equally between A and B in accordance with the partnership agreement, which reflects how A and B share the $1,000 book gain.

	A		B	
	Book	Tax	Book	Tax
Yr 1 Ending Capital Acct	$9,500	$4,000	$9,500	$9,600
Property Sale	$500	$5,900	$500	$500
Yr 2 Ending Capital Acct	$10,000	$9,900	$10,000	$10,100

If AB sells the property for less than the $9,000 book value, AB realizes tax gain of less than $5,400 and the entire gain must be allocated to A. [Treas. Reg. § 1.704-3(b)(2) Example (1)(iii)]

Note: For further discussion and examples of the traditional method of allocation, see PTM 2200 and Treas. Reg. § 1.704-3(b)(2).

4212 Traditional Method with Curative Allocations

A **curative allocation** is an allocation of income, gain, loss or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item. The traditional method with curative allocations may be used to correct distortions created by the ceiling rule. The method will be used to reduce or eliminate disparities between book and tax items of noncontributing partners. [Treas. Reg. § 1.704-3(c)(1)]

An example is if a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of IRC § 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference. The corresponding book depreciation is allocated to the contributing partner. [Treas. Reg. § 1.704-3(c)(1)]

A partnership must consistently apply the application of curative allocations. [Treas. Reg. § 1.704-3(c)(2)]

A curative allocation must be reasonable in time, amount, and type: [Treas. Reg. § 1.704-3(c)(3)]

- Reasonable in amount. They may be made only to the extent necessary to offset the effect of the ceiling rule for the tax year, or on the disposition of property, for prior tax years.
- Made over a reasonable period of time. A partnership may make curative allocations in a taxable year to offset the effect of the ceiling rule for a prior taxable year if those allocations are made over a reasonable period of time, such as over the property's economic life.
- Expected to have substantially the same effect on each partner's tax liability as the tax items limited by the ceiling rule.

Example of Reasonable Curative Allocations:
E and F form partnership EF, and agree that each partner will be allocated a 50% share of all partnership items and then EF will make allocations using the traditional method with curative allocations. E contributes an equipment with an adjusted tax basis of $4,000 and a book value (fair market value) of $10,000. The equipment has 10 years remaining on its depreciable life and is depreciated using the straight-line method. At the time of contribution, E has a built in gain of $6,000, and therefore, the equipment is IRC § 704(c) property. F contributes $10,000 of cash, which EF uses to buy inventory for resale to the customers. In EF's first year, the operating revenue is equal to the operating expenses. The

equipment creates $1,000 of book depreciation and $400 of tax depreciation for each of 10 years. At the end of the first year, EF sells the inventory for $10,700, recognizing $700 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from E's contributed equipment. Under the traditional method, E and F would each be allocated $350 of income from the sale of inventory for book and tax purposes and $500 of depreciation for book purposes. The $400 of tax depreciation would be allocated to F. Thus, at the end of the first year, E and F's book and tax capital accounts would be as follows:

	E		F	
	Book	Tax	Book	Tax
Initial Contribution	$10,000	$4,000	$10,000	$10,000
Depreciation	(500)	(0)	(500)	(400)
Sales Income	350	350	350	350
Total	$9,850	$4,350	$9,850	$9,950

Reasonable curative allocation: Because the ceiling rule would cause a disparity of $100 between F's book and tax capital accounts, EF may properly allocate to E an additional $100 of income from the sale of inventory for tax purposes. This allocation results in capital accounts at the end of EF's first year as follows:

	E		F	
	Book	Tax	Book	Tax
Initial Contribution	$10,000	$4,000	$10,000	$10,000
Depreciation	(500)	(0)	(500)	(400)
Sales Income	350	450	350	250
Total	$9,850	$4,450	$9,850	$9,850

Unreasonable curative allocation: Assume the same facts as above except that E and F choose to allocate all the income from the sale of inventory to E for tax purposes, although they share it equally for book purposes. This allocation results in capital accounts at the end of EF's first year as follows:

	E		F	
	Book	Tax	Book	Tax
Initial Contribution	$10,000	$4,000	$10,000	$10,000
Depreciation	(500)	(0)	(500)	(400)
Sales Income	350	700	350	0
Total	$9,850	$4,700	$9,850	$9,600

This curative allocation is unreasonable because the allocation exceeds the amount necessary to eliminate the difference in amounts allocated to F's book and tax capital accounts. [Treas. Reg. § 1.704-3(c)(4) Example 1(iii)(B)]

***Observation**: In the example above, the partnership has $700 income from the inventory sale, which is of the same type or character (i.e. ordinary) as the tax item limited by the ceiling rule. This income item presents an opportunity to eliminate the disparity between F's tax and book capital accounts by reallocating the income from the inventory sale for tax purposes. Absent an appropriate item to allocate, a curative allocation **cannot** be made. The remedial allocations, on the other hand, do not depend on the existence of other items of income or loss.*

Note: For further discussion and examples of reasonable curative allocations, see PTM 2230 and Treas. Reg. § 1.704-3(c)(4) Example 1.

4213 Remedial Allocation Method

In order to eliminate ceiling rule disparities between tax items of noncontributing partners and corresponding book items, a partnership may use the remedial allocation method. The partnership eliminates disparities by creating remedial items and allocating those items to its partners. [Treas. Reg. § 1.704-3(d)(1)]

Under the remedial allocation method, the partnership first determines the amount of book items (described below) and the partner's distributive shares of these items under IRC § 704(b). The partnership then allocates the corresponding tax items recognized by the partnership using the traditional method. If the ceiling rule results in a book allocation of an item to a noncontributing partner that differs from the similar tax allocation of the item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss or deduction equal to the amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in the same amount and allocates it to the contributing partner. [Treas. Reg. § 1.704-3(d)(1)]

A partnership determines the amount of book items attributable to the contributed property in the following manner:

By recovering the portion of the partnership's book basis in the property equal to the adjusted tax basis in the property at the time of the contribution in the same manner as the adjusted tax basis is recovered and the remainder of the partnership's book basis in the property (the amount by which the book basis exceeds the adjusted tax basis) by

using any applicable recovery period and depreciation method available for newly purchased property placed in service at the time of the contribution. [Treas. Reg. § 1.704-3(d)(2)]

Remedial allocations of income, gain, loss or deductions to the noncontributing partner must be of the same character as the tax item limited by the ceiling rule.

Example:
L and M form partnership LM and agree to allocate all items equally. The partnership agreement provides that allocations will be made using the remedial method and that straight-line depreciation will be used to recover excess book basis. L contributes a depreciable property with an adjusted basis of $4,000 and a fair market value of $10,000. The property is depreciated using the straight-line method with a 10-year recovery period and has a remaining depreciable life of 4 years. M contributes $10,000 in cash. Except for its depreciation deductions, LM's expenses equal its income each year for the first 10 years.

Years 1 through 4, under the remedial allocation method, LM has book depreciation for each of its first 4 years of $1,600 [$1,000 (contributing partner's adjusted basis $4,000 / remaining useful life of 4 years) plus $600 ($6,000 excess of book value over tax basis/ ***new*** *useful life of 10 years)]. Under the partnership agreement, L and M are each allocated 50% ($800) of this book depreciation. With respect to the $1,000 tax deprecation, M is allocated $800 of the tax depreciation to match his book deprecation and L is allocated the remaining $200 ($1,000 less 800) tax depreciation. No remedial allocations are being made because the ceiling rule does not result in a book allocation of depreciation that is different from the tax allocation. The allocations result in capital accounts at the end of LM's first 4 years as follows:*

	L		*M*	
	Book	*Tax*	*Book*	*Tax*
Initial Contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Depreciation (first 4 years)	*(3,200)*	*(800)*	*(3,200)*	*(3,200)*
Total	*$6,800*	*$3,200*	*$6,800*	*$6,800*

For year 5, LM has no tax depreciation but $600 of ***book*** *depreciation ($6,000 excess of initial book value over adjusted tax basis divided by the ten year recovery period applicable to the excess), which is allocated to L and M equally. Under the ceiling rule, M would be allocated $300 of book depreciation, but no tax depreciation. Since the ceiling rule would cause an annual disparity of $300 between M's allocations of book and tax depreciation, LM must allocate $300 of*

tax depreciation to M and allocate an offsetting remedial allocation to L of $300 of income, which must be of the same type as income produced by the property. At the end of the 5th year, LM's capital accounts are as follows: [Treas. Reg. § 1.704-3(d)(7), Example 1]

	L		*M*	
	Book	*Tax*	*Book*	*Tax*
End of Year 4	*$6,800*	*$3,200*	*$6,800*	*$6,800*
Depreciation	*(300)*	*0*	*(300)*	*0*
Remedial Allocation	*0*	*300*	*0*	*(300)*
Total	*$6,500*	*$3,500*	*$6,500*	*$6,500*

Note: *For further discussion and examples of remedial allocations, see* PTM 2300 *and Treas. Reg. § 1.704-3(d)(7).*

4220 Securities Partnerships

A partnership is a securities partnership if the partnership is either a management company or an investment partnership and the partnership makes book allocations in proportion to its book capital accounts. [Treas. Reg. § 1.704-3(e)(3)(iii)(A)]

A securities partnership may revalue each of its financial assets every day, making tracking of separate basis adjustments for each of many securities impractical. [T.D. 8500, December 21, 1993]

A securities partnership may use any reasonable approach to aggregate gains and losses from qualified financial assets that is consistent with the purpose of IRC § 704(c), but once it adopts an approach, it must continue to use it. [Treas. Reg. § 1.704-3(e)(3)(i)]

The regulations describe two reasonable methods for allocating gains and losses:

- Partial netting approach [Treas. Reg. § 1.704-3(e)(3)(iv)]
- Full netting approach. [Treas. Reg. § 1.704-3(e)(3)(v)]

Under the partial netting approach, tax gains and losses are netted separately. Afterwards, gains (losses) are allocated to partners who have positive (negative) capital accounts in proportion to their positive (negative) balances. The excess amounts, if any, are then allocated on a pro rata basis to all of the partners.

The full netting approach combines all tax gains and losses and allocates only a single net figure to the partners.

4230 Depreciation Recapture

The contribution of IRC §§ 1245 or 1250 recapture property to a partnership in a § 721 exchange does not result in depreciation recapture to the contributing partner unless the contributing partner recognizes gain under IRC § 731(a)(1) as a result of the contribution. [See IRC §§ 1245(b)(3), 1250(d)(3); Treas. Reg. §§ 1.1245-4(c)(1), 1.1245-4(c)(4) Example 3, 1.1250-3(c)(1), 1.1250-3(c)(2)(vi)]

The potential for depreciation recapture carries over to the partnership.

Example:
K and M form a general partnership, K & M Construction. K contributes $40,000 in cash and M contributes an equipment with a fair market value of $40,000 that has an adjusted basis of $12,000. M originally purchased the property for $50,000 and has taken $38,000 in depreciation deductions at the time of contribution.

If M had sold the equipment to K & M Construction for $40,000, he would have recognized a gain of $28,000 on the property, all of which would be treated as ordinary income from recapture of depreciation. [IRC § 1245] Depreciation recapture is not generally recognized upon contribution of property to a partnership. When a partner contributes depreciated property to a partnership in a nonrecognition transaction, the recapture provisions apply only to the extent that gain is required to be recognized on the transaction (i.e. any gain recognized from the transfer of encumbered property). [IRC § 1245(b)(3)] The partnership's basis in the equipment is $12,000. The partnership steps into M's shoes and continues to claim the depreciation deductions on the equipment using the same schedule M used prior to the contribution. [IRC § 168(i)(7)(A) and (B)] M is only deferring the recapture of depreciation since the potential recapture on the equipment carries over to the partnership. The recapture will be allocated to the partners "in the same proportion as the total gain is allocated," unless a specific special allocation of depreciation recapture is made.

If the partnership later sells the fully depreciated property, the first $50,000 of proceeds will be ordinary income from recapture. The difference between the fair market value of the equipment and M's basis at the time of contribution is allocated to M under IRC § 704(c).

4300 CONTRIBUTION OF SERVICE FOR PARTNERSHIP INTEREST

In general, the partner who contributes services for a capital interest recognizes ordinary income equal to the fair market value of the partnership interest received. See IRC § 83, Treas. Reg. § 1.721-1(b), *Lehman v. Commissioner*, 19 T.C. 659 (1953), and Revenue Procedure (Rev. Proc.) 93-27 (Rev 93-27, 1993-2 CB 343) for guidance. The contribution of services for a profits interest may result in different consequences. There are various nuances to the contribution of services for a capital or profits interest.

PTM 4310 Service in Exchange for Profits Interest in Partnership
PTM 4320 Valuation of Profit Interest in Exchange for Services
PTM 4330 Contribution of Services in Exchange for a Capital Interest
PTM 4340 Valuation of Capital Interest

4310 Service in Exchange for Profits Interest

A **profits interest** is defined as any partnership interest other than a capital interest. [Rev. Proc. 93-27; 1993-2 C.B. 343] See PTM 4330 for the definition of the capital interest.

In general, if a person receives a profits interest in a partnership in exchange for services performed in anticipation of being a partner, the event is not a taxable transaction for the partnership or the partner. The Internal Revenue Service (IRS) will not treat the receipt of such an interest as a taxable event for the partner or the partnership. (Rev. Proc. 93-27.) Rev. Proc. 93-27 does not represent the position of the IRS on the substance of the law; rather its effect is to assure taxpayers that the IRS will not attempt to tax transfers of profits interests in most, but not all, typical situations in which partnership interests are transferred for services.

The exceptions to this rule are:

- If the profits interest relates to a substantially certain and predictable stream of income from partnership assets (e.g. income from high-quality debt securities or high-quality net leases);
- Within two years of receipt, the partner disposes of the profits interest; or
- The profits interest is a limited partnership interest in a publicly traded partnership (within the meaning of IRC § 7704(b)).

Prior to Rev. Proc. 93-27, the Courts held that the receipt of a profits interest in a partnership in exchange for the performance of services was a taxable event.

- In the *Diamond* decision, 56 T.C. 530 (1971), the Tax Court held that the receipt of a profits interest in a partnership in exchange for the performance of services was a taxable event. In this case, the taxpayer was a mortgage broker and arranged financing for a building owned by the partnership. In return, the taxpayer received an interest in partnership profits and losses. The interest was freely transferable and was sold shortly after receipt for $40,000. The taxpayer treated the gain on the sale as a capital gain. The court held that the receipt of the profits interest was compensation income under IRC § 61 and therefore was ordinary income. The court found that since the interest was sold within three weeks after it was received for $40,000, the interest was worth at least that amount when it was received by the taxpayer. The Seventh Circuit affirmed the decision in this case, but urged the Commissioner to promulgate clarifying regulations. The affirming opinion implied that the profits interest received by the taxpayer constituted taxable income upon receipt because its market value was capable of determination at the time of receipt. [492 F.2d 286 (7th Circuit, 1974)]
- In *Campbell v. Commissioner*, T.C. Memo 1990-162, rev'd 943 F.2d 815 (8th Circuit, 1991), the Tax Court held that a taxpayer who received an interest in the future profits of a partnership in exchange for services recognized immediate taxable income equal to the economic and tax benefit value of the interest. The Tax Court reached this decision by finding that the partnership interest was property for the purposes of applying IRC § 83 (treatment of property received in exchange for services) The Eighth Circuit reversed, however, on the grounds that unlike in *Diamond* the value of the profits interest in *Campbell* was speculative, and without a fair market value when received should not have been included in income at that time.

See McKee, Nelson & Whitmire, *Federal Taxation of Partnerships*, ¶ 5.02[6] Fourth Edition for further details.

4320 Valuation of Profit Interest in Exchange for Services

Rev. Proc. 93-27 provides that the receipt of a **profits interest** for services rendered by a partner is taxable in three separate situations. The valuation required in each situation is as follows [Practitioners Publishing Co, Tax Planning Guide, Chapter 3]:

- If the profits interest related to a substantially certain and predictable income stream, the value of the interest will probably be the present value of the income stream.
- If the profits interest received is disposed of within two years of receipt, the value will probably be determined at the time of disposition and equal the value on the date of disposition.
- If the profits interest is an interest in a publicly traded partnership, the value will probably be the market value of similar interests.

Additional Information: Rev. Proc. 2001-43, 2001-2 C.B. 191, REG-105346-03, 70 Fed. Reg. 29675 (5/24/05) and Notice 2005-43, 2005-1 CB 1221 provide further guidance on profit interest acquired in exchange for services.

Rev. Proc. 2001-43 clarifies Rev. Proc. 93-27 by providing guidance on the treatment of the grant of a profit interest that is substantially nonvested. In addition, the IRS and Treasury issued proposed regulations, accompanied by Notice 2005-43 which contains a draft revenue procedure that will obsolete Rev. Proc. 93-27 and 2001-43 and provide updated guidance on valuing partnership interests. Under the proposed regulations and draft revenue procedure, all partnership interests, whether capital or profits, would be subject to IRC § 83; but the amount subject to IRC § 83 would be determined based on the liquidation value of the interest (which should be zero for profit interests). California does not conform to the proposed regulations.

4330 Contribution of Services in Exchange for a Capital Interest

A **capital interest** is defined as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." [Rev. Proc. 93-27]

A person who provides services in exchange for an interest in partnership capital recognizes compensation income [Treas. Reg. § 1.721-1(b)(1)]. Under IRC § 83, a partner receiving a capital interest in exchange for services is taxed at the time the interest is received or "substantially vested" if the interest is subject to restrictions. If the interest is substantially nonvested, taxation of the interest is delayed until it vests unless the partner makes an election under IRC § 83(b). Property becomes substantially vested "when it is either transferable or not subject to a substantial risk of forfeiture." [Treas. Reg. § 1.83-1(a); *Hensel Phelps Construction Co*., 74 TC 939, 954 n.6 (1980), aff'd, 703 F.2d 485 (10th Cir. 1983)]

If substantial risk of forfeiture exists, the service partner may elect under IRC § 83(b) to be taxed at the time of receiving the interest on the "restricted" interest. The interest must be valued without taking into consideration the substantial risk of forfeiture, and the election must be made within 30 days of the receipt of the interest. [IRC § 83(b)(2)]

Tax consequences also result to the partnership from the transfer of a capital interest to a partner in exchange for services rendered to the partnership. Generally, the value of the interest transferred is a payment that is either deductible or capitalized by the partnership, depending on the nature of the services performed. (See IRC §§ 83(h) and 707) For instance, if the partner contributes services to syndicate the partnership, the partnership must capitalize the value of the interest transferred under IRC § 709.

4340 Valuation of Capital Interest

If property is substantially vested at the time it is transferred, it is required to be valued at the time of the transfer. [Treas. Reg. § 1.83-1(a); *Hensel Phelps Construction Co*., 74 TC 939, 954 n.6 (1980), aff'd, 703 F2d 485 (10th Cir. 1983)] Otherwise, it is generally valued as it becomes substantially vested.

There are several methods used to determine the value of a capital interest in a partnership. The methods which have been allowed by the courts include:

- Determining the fair market value by the prices of comparable interests in the partnership sold near the time of the transfer [*United Title Insurance Co. v. Commissioner* (1988) TC Memo 1988-38];
- Determining the value the interest received by reference to the value of the services performed [*Hensel Phelps Construction Co.*, (1980) 74 TC 939, aff'd (1983, CA 10) 51 AFTR 2d 83-1006, 703 F.2d 485, 83-1 USTC];
- Determining the amount the contributing partner would receive upon liquidation.
  [McKee, Nelson & Whitmire, *Federal Taxation of Partnerships*, ¶ 5.02[8][b] Fourth Edition

4400 TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP

4410 Partner Acting in Capacity as a Partner

The legislative history of IRC § 707(a)(2)(A) describes in detail the factors that must be considered under the regulations in determining whether an allocation and distribution is made to a partner acting in his capacity as a partner, or whether the arrangement constitutes a payment for services or property to a partner acting in a capacity other than as a partner.
[Senate Report No-169, 98th Congress, (1984) Vol. 1 p.225 -232]

- The first factor, and the most important, is whether the payment is subject to the risk of the partnership's business ("significant entrepreneurial risk"). To the extent an allocation and distribution to a partner is reasonably certain, the partner is acting in an individual capacity and should be treated as an independent contractor.
- The next two factors are the duration of the payee's partnership status and the timing of the payment in relation to the provision of services. If a partner status is transitory, an allocation and distribution resemble a fee rather than a return of investment. If an allocation and distribution is close in time to the performance of services or transfer of property, the transactions are likely to be considered related. The reasoning behind this is that the risk of nonpayment increases with time.
- The fourth factor centers on the recipient partner's motivation in becoming a partner, i.e., whether based on the facts and circumstances, it appears that tax considerations caused the association. This factor is not weighed significantly in the analysis.
- The fifth factor is whether the allocation in question is disproportionately large in relation to the recipient partner's interest in the partnership's profits. A short-term allocation that is greater than the recipient's profits interest may suggest that the allocation is a disguised fee.

Additional Information: The Proposed Reg. § 1.707-2(c) released on 07/22/2015 would add an additional factor: whether the allocations or distributions with respect to different services received from one or related persons are different, and the terms of the differing allocations or distributions are subject to levels of significant entrepreneurial risk that vary significantly. California does not conform to the proposed regulation. See McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 14.02[4][a] Fourth Edition for further details.

Example:
A partnership is formed to invest in stock. The partnership admits a stockbroker as a partner. The broker agrees to effect trades for the partnership without the normal brokerage commission. In exchange for an interest in the partnership, the broker contributes 51% of partnership capital and receives a 51% interest in residual partnership profits and losses. In addition, the broker receives an allocation of gross income that is computed in a manner that approximates his foregone commission. It is expected that the partnership will have sufficient gross income to make the allocation. The agreement provides that the broker will receive a priority distribution of cash from operations up to the amount of the allocation.

Even though the broker's allocation appears contingent and not fixed as to an amount, it is computed by means of a formula similar to a normal brokerage fee and varies according to the services performed rather than according to the income of the partnership. Therefore, the Senate Report concludes that this contingent gross income allocation should be treated as a fee under IRC § 707(a) rather than as a distributive share and partnership distribution. It is assumed that the partnership will have sufficient income to make the allocation.

If a partner provides services or transfers property to a partnership and there is a direct or indirect allocation and distribution to that partner and the performance of the service and the allocation and distribution, when viewed together, are properly characterized as a transaction between the partnership and a partner acting other than in his capacity as a partner, the allocation and distribution are treated as a transaction between the partnership and an outsider. [IRC § 707(a)(2)(A)]

The purpose of this rule is to prevent partnerships from receiving a deduction for capital expenditures and to prevent partners from converting ordinary income into capital gain. [Senate Report No-169, 98th Congress, (1984) Vol. 1 p.225 -232]

These provisions do not apply to every situation in which a partner obtains a partnership interest by contributing services or property to the partnership. This section applies to allocations that are determined to be related to the contribution of property or services that have economic effect of payment for the property or services. [Senate Report No-169, 98th Congress, (1984) Vol. 1 p.225 -232]

Example:
P Associates is a partnership with three equal partners. It has $100,000 of income (determined without regard to syndication costs). It pays L, a partner, $10,000 for services in connection with the acquisition of land. The payment is for services performed outside of L's capacity as a partner. Therefore, the partnership must capitalize it. Each partner's share of the partnership's income is $33,333. (L has an additional $10,000 of income for the performance of services.)

4420 Disguised Sales – General

A partner's contribution of property to a partnership followed by a partnership distribution to the same partner may be treated as a sale between the partnership and a non-partner. [IRC § 707(a)(2)(B)] A contribution and a related distributions will be characterized as a sale if based on the facts and circumstances:

- The transfer of money or other consideration would not have been made except for the transfer of property; and
- In cases in which the transfers are not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. [Treas. Reg. § 1.707-3(b)(1)]

If a partner contributes property to a partnership and within 2 years receives a distribution of money or other property from the partnership, the transaction is presumed to be a sale unless the facts and circumstances clearly establish that the transfers do not constitute a sale. [Treas. Reg. § 1.707-3(c)]

Transfers made more than two years apart are presumed not to be a sale. [Treas. Reg. §§ 1.707-3(d), 1.707-3(f) Example 5, 7]

- Each of these presumptions may be rebutted only by facts and circumstances (listed below) that "clearly establish" otherwise. [Treas. Reg. §§ 1.707-3(c)(1), 1.707-3(d) & (f) Example 3, 5, 6, 8]
- Just because a subsequent distribution occurs more than two years later does not automatically mean that the disguised sale treatment is not applicable.

Example:
C transfers undeveloped land to the CD partnership in exchange for a partnership interest. The partnership intends to construct a building on the land. At the time of the transfer, the land has an adjusted basis of $500,000 and a fair market value of $1,000,000. The partnership agreement provides that the partnership will distribute $900,000 to C upon completing construction of the building. If the transfer of the money is made within two years of the transfer of land, the transfer is presumed to be a partial sale of the transferred land. C may rebut the presumption by showing that the facts and circumstances clearly establish that the $900,000 payment to C would be make without regard to his transfer of the land or that CD's obligation to make the $900,000 payment depended, at the time of the transfer, on the entrepreneurial risks of partnership operation. [Treas. Reg. § 1.707-3(f) Example 3]

Transfers resulting from a **termination of a partnership** by means of either discontinuing the partnership business or sale or exchange of more than 50% interest in the partnership are **disregarded**. [Treas. Reg. § 1.707-3(a)(4)]

Note: Per Section 13504(c) of P.L 115-97, the Tax Cuts and Jobs Act (2017) (TCJA), for taxable years beginning after December 31, 2017, a sale or exchange of 50 percent or more of the interest in a partnership does not cause a technical termination of the partnership any longer for federal purposes. California conformed to this amendment to IRC § 708(b) by the TCJA pursuant to Laws 2019, Ch. 39, §16 (AB 91), which added R&TC § 17859. R&TC § 17859 is applicable to taxable years beginning on or after January 1, 2019. However, a partnership may elect to apply the new law to a partnership taxable year beginning during 2018 in order to avoid a California-only technical termination for California tax purposes for the 2018 taxable year.

The IRS has listed facts and circumstances, each of which indicates that the transaction is a disguised sale because at the time of the earlier transfer, the later transfer wasn't dependent on "entrepreneurial risks" of partnership operations [Treas. Reg. § 1.707-3(b)(2)]:

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of the transfer;
(ii) That the transferor has a legally enforceable right to the subsequent transfer;
(iii) That the partner's right to receive the transfer of money or other consideration is secured, taking into account the period during which it was secured;

(iv) 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;
(v) 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;
(vi) That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to make the transfer, taking into account the likelihood that the partnership will be able to incur the debt;
(vii) 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;
(viii) 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) 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
(x) That the partner has no obligation to return or repay the money or 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 the obligation is small in relation to the amount of money or other consideration transferred by the partnership.

Example:
A and B form an equal partnership. A contributes property having a fair market value of $100,000 and an adjusted basis of $50,000. B contributes $50,000 in cash. A and B have capital accounts that reflect $100,000 and $50,000 respectively. During the course of the year, the partnership distributes $50,000 to A. Under the rules of IRC §§ 721 and 731, the contribution and distribution would be tax free. But, under the rules of IRC § 707(b)(2)(B), if a partner transfers money or other property to a partnership and the partnership makes a related transfer of money or other consideration, the transaction is treated as a sale of property to the partnership. In this case, A must recognize a gain of $50,000 on the sale.

4430 Effects of Liability on Property

The disguised sale rules may also apply if the contributing partner received a loan related to the property in anticipation of the contribution to the partnership

and the partnership or other partners assumes responsibility of repayment of the loan.

IRC §§ 721 & 731 are still applicable (tax free contribution and distribution) if:

- Partnership liabilities are not incurred in anticipation of the contribution; or
- Partnership liabilities are not incurred in anticipation of the distribution.

[Senate Report No. 169, 98th Congress (1984) Volume 1, p. 231]

The fact that a contribution has the effect of shifting liabilities from the transferor partner to the partnership, creating a deemed distribution under IRC § 752(b) will not always constitute a disguised sale. [*Oehschlager v. Comr.,* TC Memo 1988-210; Cf. 4431 infra]

To address the issue relating to liabilities, the Treasury determined that only "nonqualified liabilities" which are incurred in anticipation of the transfer of the property to the partnership should be fully subject to the disguised sale rules. On the other hand, "qualified liabilities" are subject to the disguised sale rules only to a very limited extent. [Treas. Reg. § 1.707-5]

Note*:* For a detailed discussion of liabilities, see PTM 5000.

4440 Qualified Liabilities – Definition

A liability assumed or taken subject to by the partnership in connection with a transfer of property to the partnership by a partner is a qualified liability if:

- The liability was incurred by the partner more than two years before the earlier of the date the partner agreed in writing to transfer the property or the date that the transfer of property to the partnership occurred ("the two year period"). [Treas. Reg. § 1.707-5(a)(6)(i)(A)] The liability must have encumbered the property for the entire two-year period;
- The liability was incurred by the partner within the two-year period, but was not incurred in anticipation of the transfer of property to the partnership. [Treas. Reg. § 1.707-5(a)(6)(i)(B)] There is a presumption that a liability incurred within two years of a transfer was incurred in anticipation of the transfer unless the facts and circumstances clearly show otherwise; [Treas. Reg. § 1.707-5(a)(7)(ii)]
- The liability is, under the rules of Treas. Reg. § 1.163-8T (relating to the allocation of debt for purposes of the limitations on interest expense deductions), allocable to capital expenditures with respect to the property; [Treas. Reg. § 1.707-5(a)(6)(i)(C)]; or

- The liability was incurred in the ordinary course of the trade or business in which the property transferred to the partnership was used or held, but only if all of the assets related to that trade or business are transferred to the partnership other than assets that are not material to the continuation of the trade or business, [Treas. Reg. § 1.707-5(a)(6)(i)(D)]; and
- To be considered a qualified liability, a recourse liability cannot exceed the fair market value of the transferred property (less the amount of senior priority liabilities that encumber the property or are liabilities described in the last two points above) at the time of the transfer. [Treas. Reg. § 1.707-5(a)(6)(ii)]

Note: The current Treas. Reg. § 1.707-5, which is effective 10/05/2016, would also treat a liability as "qualified liability" if the liability was not incurred in anticipation of the transfer of the property to a partnership, but was incurred in connection with a trade or business in which property transferred 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)(E)] California has not conformed to the changes made by the regulation.

Example:
A and B form a partnership. A transfers $500,000 in cash to the partnership and B transfers an office building. At the time of the transfer, the building has a basis of $400,000 and a fair market value of $1,000,000 and was encumbered by a $500,000 nonrecourse liability that B incurred 12 months prior to the transfer. The proceeds were used by B to purchase other property. There were no facts that rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Accordingly, the liability is not a qualified liability. [Treas. Reg. § 1.707-5(f), Example 1]

4450 Assumption of Qualified Liabilities

If a transfer of property to partnership is not otherwise considered a sale, the assumption of a qualified liability by a partnership does not cause the transfer to be treated as a sale. [Treas. Reg. § 1.707-5(a)(5)(i)]

If the transfer is treated as a sale, the assumption or taking the property subject to a qualified liability is treated as additional consideration in the sale only to the extent of the lesser of:

- The amount of consideration which the partner would be deemed to receive under the rules of assuming a nonqualified liability (see below); [Treas. Reg. § 1.707-5(a)(5)(i)(A)], or

- The amount obtained by multiplying the amount of the qualified liability by the partner's net equity percentage with respect to the property. [Treas. Reg. § 1.707-5(a)(5)(i)(B)]

A partner's net equity percentage is equal to the percentage obtained by dividing:

- The total amount of money or other consideration received by the partner from the partnership (other than amounts with regard to the qualified liability) that are treated as proceeds from the sale of the property, [Treas. Reg. § 1.707-5(a)(5)(ii)(A)]
- By the excess of the fair market value of the property at the time it is transferred to the partnership over
    - Any qualified liability which encumbers the property,
    - Any qualified liability allocable to the property if allocable to capital expenditures, or
    - Any qualified liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held, but only if all of the assets related to that trade or business are transferred, other than assets that are not material to the continuation of the trade or business. [Treas. Reg. § 1.707-5(a)(5)(ii)(B)]

Example 1:
F transfers property Z to partnership AF. At the time of the transfer, the property had a fair market value of $165,000, a basis of $75,000 and was encumbered by a $75,000 recourse liability that met the rules for a qualified liability. Assume that F's share of the liability is $25,000.

Since the liability is a qualified liability and no other transfers of money or other consideration were made to F, the assumption of liability by AF is not treated as a sale. [Treas. Reg. § 1.707-5(f), Example 5]

Example 2:
Assume the same facts as the previous example, except that the partnership transfers $30,000 to F in consideration for the transfer in addition to assuming the liability. Since the partnership transferred money to F, the assumption of the $75,000 liability is treated as additional consideration to F to the extent of the ***lesser*** *of (1) the amount that the partnership would be treated as transferring to F if the liability were a nonqualified liability ($75,000 - 25,000 = 50,000) or (2) the amount obtained by multiplying the amount of the qualified liability ($75,000) by F's net equity percentage with respect to the property. F's net equity percentage is equal to the percentage determined by dividing the aggregate amount of*

money or other consideration from the partnership to the partner ($30,000) by the excess of the fair market value of the property at the time it is transferred to the partnership over any qualified liability encumbering the property ($165,000 - 75,000 = 90,000) ($30,000 / 90,000 x 75,000 = 25,000) Thus, the assumption of liability would be treated as a transfer of an additional $25,000 of consideration to F. As a result, F is treated as receiving a total of $55,000 of consideration in the sale. F has a gain of $30,000, since his basis in the sale portion was $25,000 (55,000 / 165,000 x 75,000) [Treas. Reg. § 1.707-5(f), Example 6]

Note: *For more examples, see Treas. Reg. § 1.707-5(f).*

4460 Assumption of Nonqualified Liabilities

If a partnership assumes or takes property subject to debt other than qualified liabilities (defined in PTM 4440), the partnership is treated as transferring consideration to the extent the amount of the liability exceeds the partner's share of liability immediately after the partnership assumes or takes the property subject to the liability. [Treas. Reg. § 1.707-5(a)(1)]

Example:
A & B form partnership AB. A transfers $500,000 in cash to AB and B transfers an office building. At the time of the transfer, the building has a basis of $400,000 and a fair market value of $1,000,000 and was encumbered by a $500,000 nonrecourse liability that is not a qualified liability. In accordance with the partnership agreement, B's share of the liability is 50% or $250,000. The partnership's taking the building subject to the liability is treated as a transfer of $250,000 to B ($500,000 - 250,000 (B's share of liability)). This results in a $150,000 gain to B ($250,000 -100,000 (400,000 x 25%) basis allocated to the sale portion). [Treas. Reg. § 1.707-5(f), Example 1]

4470 Consequences of Disguised Sale Treatment

A transfer of property by a partner to a partnership and a transfer of consideration by a partnership to a partner are treated as a sale or exchange of that property to the partnership by the partner acting in a non-partner capacity (see PTM 4410). The sale is considered to have taken place on the date that the partnership is considered the owner of the property. [Treas. Reg. § 1.707-3(a)(2)]

If the fair market value of the property transferred to the partnership is greater than the consideration transferred to a partner pursuant to a sale, the transfer is treated as a sale in part and a contribution in part.

Example:
A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in the partnership. At the time of the transfer, property X has a fair market value of $4,000,000 and an adjusted tax basis of $1,200,000. Immediately after the transfer, the partnership transfers $3,000,000 in cash to A.

Assume that the transfer is treated as a sale of property to the partnership (disguised sale). Because the amount of cash A receives on April 9, 1992, does not equal the fair market value of the property, A is considered as having sold a portion of property X with a value of $3,000,000 to the partnership in exchange for cash. Accordingly, A must recognize $2,100,000 of gain ($3,000,000 amount realized less $900,000 adjusted basis ($1,200,000 multiplied by $3,000,000/4,000,000). Assuming A receives no other consideration for the sale of the property, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,000,000 of the fair market value of the property with an adjusted basis of $300,000 ($1,200,000 less $900,000). [Treas. Reg. § 1.707-3(f), Example 1]

Note: *When a transaction is recharacterized from a contribution to a disguised sale, in addition to the recognition of gain or loss, the partnership's basis in the property as well as the partner's basis in the partnership may be adjusted.*

4480 Exceptions – Guaranteed Payments and Preferred Returns

In general, the following payments to a partner are not treated as payments under the disguised sale rules: [Treas. Reg. § 1.707-4(a)(1)(i)]

- Guaranteed payments. (see PTM 4481)
- Preferred returns. (see PTM 4482)
- Operating cash flow distributions [Treas. Reg. § 1.707-4(b)]
- Preformation expenditure reimbursements [Treas. Reg. § 1.707-4(d)]

4481 Guaranteed Payments

Guaranteed payments for capital are 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. [Treas. Reg. § 1.707-4(a)(1)(i)]

In many cases, a legitimate guaranteed payment could be treated as part of a disguised sale since it is not subject to entrepreneurial risks of partnership operations if tested under Treas. Reg. § 1.707-3. Therefore, under these regulations, a legitimate guaranteed payment for capital is excluded from the

general rule and is not treated as a disguised sale. [Treas. Reg. § 1.707-4(a)(1)(i)]

- A transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital and that is reasonable is presumed to be a guaranteed payment for capital and not part of a disguised sale unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale. [Treas. Reg. § 1.707-4(a)(1)(ii)]
- A guaranteed payment or preferred return is considered reasonable only to the extent the transfer is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement. [Treas. Reg. § 1.707-4(a)(3)]
- A transfer of money that is made to a partner during any partnership taxable year and that 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. [Treas. Reg. § 1.707-4(a)(3)(ii)]

4482 Preferred Returns

A **preferred return** is a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain. [Treas. Reg. § 1.707-4(a)(2)]

The disguised sale rules are not intended to prevent a partner from receiving a partnership interest for a contribution of property which interest grants him priorities or preferences regarding distributions, if the arrangement is not in substance a disguised sale. [Senate Report No. 169, 98th Congress (1984) Volume 1]

Example 1:

A transfers a property with a fair market value of $100,000 to partnership AB. At the time of the transfer, the partnership agreement is amended to provide that A is to receive a guaranteed payment for the use of A's capital of 10% of the fair market value of the transferred property in each of the three years following the transfer. The partnership agreement provides that partnership net taxable income and loss will be allocated equally between partners A and B, and the partnership cash flow will be distributed in accordance with the allocation of partnership net taxable income and loss. The partnership would be allowed a deduction in the year paid if the transfers to A are treated as guaranteed payments under IRC § 707(c). The partnership agreement does not provide for payment of a preferred return other than the guaranteed payment to be paid to A. The transfer is characterized as a guaranteed payment for capital and is determined without regard to partnership income. The transfer is also reasonable within the meaning of Treas. Reg. § 1.707-4(a)(3). Therefore, the transfer is presumed to be a guaranteed payment. The presumption relating to transfers made within two years of each other does not apply to this transfer. [Treas. Reg. § 1.707-4(a)(4) Example 1]

Example 2:
C and D form partnership CD. C transfers a property with an adjusted basis of $20,000 and a fair market value of $100,000 to CD in exchange for a partnership interest. D manages the partnership operations and makes no capital contribution to CD. The partnership agreement provides that C is to receive an annual payment characterized as a guaranteed payment of $8,333 for the use of his capital for the first four years following the transfer.

The partnership agreement also provides that partnership net taxable income and loss will be allocated 75% to C and 25% to D, and that partnership cash flow (determined without regard to the guaranteed payment) will be distributed in the same way, except that guaranteed payments made to C are payable solely out of D's share of partnership cash flow. If D's share of the partnership cash flow is insufficient to make the guaranteed payment to C, then D is obligated to contribute the difference to the partnership, even in the event of a liquidation of the partnership. Thus, the effect of the guaranteed payment arrangement is that the guaranteed payment is funded entirely by D. The partnership complies with the requirements of Treas. Reg. § 1.704-1(b)(2)(ii)(b). Suppose at the time the partnership was formed, the partnership or D could borrow $25,000 (equivalent to 25% interest in the partnership's capital assets pursuant to a loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of approximately 12% and that the highest applicable federal rate in effect at the time of the transfer is 10%.

The transfer of money to C under the partnership agreement is characterized by the parties as a guaranteed payment for capital, is determined without regard to partnership income, and is reasonable, the transfer is presumed to be a guaranteed payment, rather than a sale. (However, it should be noted that "a party's characterization of a payment is, in fact, a guaranteed payment for capital will not control in determining whether a payment is in fact a guaranteed payment for capital." [Treas. Reg. § 1.707-4(a)]) The transfer will not be treated as a sale unless the facts and circumstances establish that the transfer is not a guaranteed payment for capital and is part of a sale.)

For the first four years of partnership operations, C receives guaranteed payments of $33,332 in accordance with the partnership agreement. If the characterization of the payments is respected, C would be allocated $24,999 (75% of $33,332) of the deductions that would be claimed by the partnership for those payments, which leaves C's capital account approximately $25,000 less than it would be if the guaranteed payments had not been made. The outcome is the guaranteed payments have the effect of offsetting approximately $25,000 of the credit made to C's capital account for the property transferred to the partnership by C. C's capital account is approximately equal to the capital account C would have had if C had contributed 75% of the property to the partnership. The effect of D's funding the guaranteed payment (either through reduced distributions or additional contribution) to C is that D's capital account is approximately equal to the capital account that D would have had if D contributed 25% of the property (or $25,000 cash). A $25,000 loan requiring equal payments of principal and interest over a four-year term at an annual interest rate of 12% would have resulted in annual payments of $8,230.86 that includes principal and interest. Therefore, the guaranteed payments effectively put the partners in the economic position that they would be in if D had bought a 25% interest in the property from C (financed at the current market interest rate) and then C and D contributed their interests' in the property to the partnership. Accordingly, D has effectively purchased through the partnership a 25% interest in the property from C.

Under these facts, the presumption that the transfers to C are guaranteed payments for capital is rebutted, because the facts and circumstances clearly establish that the transfers are part of a sale and not guaranteed payments for capital. Under Treas. Reg. § 1.707-3(a), C and the partnership are treated as if C had sold a one-quarter interest in the property to the partnership in exchange for a promissory note evidencing the partnership's obligation to make the guaranteed payment. [Treas. Reg. § 1.707-4(a)(4), Example 2]

4500 DISTRIBUTIONS OF CONTRIBUTED PROPERTY

4510 General

If a partner contributes a property with a basis different from its fair market value at the time of contribution to a partnership (IRC § 704(c) property) and within seven years of the contribution, the partnership distributes the property to a noncontributing partner, the distributed property is treated as sold by the partnership for its fair market value at the time of the distribution.

The contributing partner must recognize any gain or loss from this constructive sale in the amount equal to the built in gain or loss in the property. [IRC § 704(c)(1)(B)] (See PTM 4200) No gain or loss is recognized if the property is distributed to the contributing partner. [Treas. Reg. § 1.704-4(c)(2)]

The period during which gain is recognized on distributions of contributed property begins on and includes the date of contribution. [Treas. Reg. § 1.704-4(a)(4)(i)]

The rules requiring recognition of gain or loss on distributions of contributed property do not apply to deemed distributions resulting from partnership terminations. [Treas. Reg. § 1.704-4(c)(3)]

See PTM 2500 and PTM 2600 for more discussion regarding distributions of contributed property and the seven year rule.

Note: A distribution of the contributed property may trigger both IRC §§ 704(c)(1)(B) and 737 and subject both the contributing and the distributee partners to gain recognition. For example, within seven years of the contribution, the contributed property is distributed to a partner other than the contributing partner who also has precontribution gain at the time of the distribution. In such case, the contributing partner must recognize his precontribution gain (up to the realized gain on the deemed sale) under IRC § 704(c)(1)(B); and the distributee partner must recognize his net precontribution gain under IRC § 737. See PTM 6000 for more discussion regarding property distributions.

Observation: IRC §§ 707(a)(2)(B), 704(c)(1)(B), and 737 contain disguised sale rules designed to identify and characterize a contribution of property to partnership followed by partnership distributions as a sale or exchange when the two transfers are sufficiently related. IRC §§704(c)(1)(B) and 737 apply only to transfers that are not recharacterized by § 707(a)(2)(B).

4520 Exchanges of Contributed Like Kind Property

If a partner contributes property to a partnership, and the partnership distributes the contributed property to a non-contributing partner within seven years, and the partnership distributes a like kind property (within the meaning of IRC § 1031) to the contributing partner no later than the earlier of 180 days following the date of the distribution to the non-contributing partner, or the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the noncontributing partner. The amount of gain or loss, if any, that the contributing partner would otherwise have recognized under IRC § 704(c)(1)(B) would be reduced by the amount of built in gain or loss in the distributed like kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like kind property is determined as if the like kind property were distributed. [Treas. Reg. § 1.704-4(d)(3)]

Example:
A, B, and C form partnership ABC as equal partners. A contributes Land X, with a fair market value of $20,000 and an adjusted tax basis of $10,000. B and C each contribute $20,000 cash. The partnership subsequently buys Land Y, with a fair market value and adjusted tax basis of $8,000. The fair market value of Land Y subsequently increases to $10,000. Land X and Land Y are like kind properties.

Four years later, Land X is distributed to B in a current distribution. At the same time, Land Y is distributed to A in a current distribution. The distribution of Land Y does not result in the contribution of Land X being properly characterized as a disguised sale to the partnership under Treas. Reg. § 1.707-3. A's basis in Land Y is $8,000 under IRC § 732(a)(1). A therefore has $2,000 of built in gain in Land Y ($10,000 fair market value less $8,000 adjusted tax basis).

A would generally recognize $10,000 of gain under IRC § 704(c)(1)(B) on the distribution of Land X, the difference between the fair market value ($20,000) of the property and its adjusted tax basis ($10,000). This gain is reduced, however, by the amount of the built in gain of Land Y in the hands of A. As a result, A recognizes

only $8,000 of gain on the distribution of Land X to B under IRC § 704(c)(1)(B) and this section. [Treas. Reg. § 1.704-4(d)(4) Example 1]

4530 Distribution of Contributed Property Anti-abuse Rules

If the principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of IRC § 704(c)(1)(B), the IRS can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the meaning of this section. [Treas. Reg. § 1.704-4(f)(1)]

Whether a tax result is inconsistent with those rules must be determined based on all the facts and circumstances.

Example:

On January 1, 2000, A, B, and C form partnership ABC as equal partners. A contributes land with a fair market value of $10,000 and an adjusted tax basis of $1,000. B and C each contribute $10,000 cash.

On December 31, Year 6, the partners desire to distribute the land to B in complete liquidation of B's interest in the partnership. If the land were distributed at that time, A would recognize $9,000 IRC § 704(c)(1)(B) gain that is the difference between the fair market value and adjusted basis, because the land was contributed to the partnership less than seven years ago.

On becoming aware of this potential gain recognition, and with a principal purpose of avoiding such gain, the partners amend the partnership agreement on December 31, Year 6 and take other steps necessary to provide that substantially all of the economic risks and benefits of the land are borne by B, and that substantially all of the economic risks and benefits of all other partnership property are borne by A and C.

The partnership holds the land until January 5, Year 8, at which time it is distributed to B in complete liquidation of B's interest in the partnership.

Although the actual distribution took place more than seven years after its initial contribution, the steps taken by the partnership in Year 6 are equivalent of an actual distribution of the land to B in complete liquidation of B's interest as of that date. Allowing the contributing partner to avoid recognition of gain on this transaction would undermine the purpose of IRC § 704(c)(1)(B) and the regulations. As a result, the steps taken by the partnership on December 31, Year 6 are treated as causing a

distribution of the land to B on that date, and A recognizes gain of $9,000 at that time. [Treas. Reg. § 1.704-4(f)(2) Example 1]

4540 Contribution to an Investment Partnership

If a partner contributes property to a partnership which may be classified as an investment company (See PTM 4550) **and** if "diversification" (See PTM 4560) of the contributor's investment is found to occur, the contributing partner must recognize gain, but not loss, realized on the transfer. [IRC §§ 721(b), 351(e), Treas. Reg. § 1.351-1(c)(1)] [Senate Report No. 938, 94th Cong., 2d, pt.2 at 43 (1976).]

The gain recognized is equal to the excess of the value of the partnership interest received in the exchange over the adjusted basis of the assets contributed to the partnership. [IRC § 1001] If the value of the partnership interest cannot be determined, the value of the assets transferred to the partnership may be used. [*Philadelphia Park Amusement Co. v. U.S., 126 F. Supp. 184 (Ct. Cl 1954); Farid-Es-Sultaneh v. Comr., 160 F.2d 812(2nd Cir. 1974)*]

Once a partnership is classified as an investment partnership, the transfer of **any** appreciated property that results in diversification of the contributor's investment is subject to gain recognition; this includes real estate or other assets.

***Example 1**:*
J owns 100 shares of common stock in a publicly traded corporation. The shares have a basis of $10,000 and a fair market value of $20,000. J transfers the stock to JB Partnership in exchange for a 10% interest in the partnership. JB is an investment partnership by definition. The partnership interest J receives is presumed to be worth $20,000. J recognizes $10,000 capital gain upon the transfer. The partnership's basis in the stock received is $20,000. J's basis in his partnership interest is $20,000. [IRC § 722 states basis includes gain recognized under IRC § 721(a)]

Example 2:
N owns a parcel of land used as a parking lot for his retail business. N contributes this land to a partnership that is an investment company immediately after the contribution. The partnership intends to sell its securities and use the proceeds to construct a shopping plaza on the land contributed by N. N's basis in the land is $10,000 and the value of the land is $18,000. N must recognize $8,000 IRC § 1231 gain (since the property was used in the

contributing partner's trade or business) on the contribution of land to the partnership. [Example from Tax Management, Portfolio 711-2nd: Partnerships – Formation and Contributions of Property or Services IIB4c.]

Example 3:
J owns 100 shares of common stock in a company listed on the New York Stock Exchange. The stock has a basis of $40,000 and a fair market value of $30,000. J held this stock as an investment. J transfers this stock to ABC Partnership, a partnership investment company, in exchange for a 10% interest in the partnership. J cannot report the loss on the transfer of stock to the partnership. J's basis in his partnership interest is $40,000. The partnership's basis in the stock received under the general rule of IRC § 723 is $40,000. However, IRC § 704(c)(1)(c) provides that the partnership's basis in contributed built in loss property is equal to the fair market value of the property and the amount of the built in loss is taken into account only with respect to allocating items to the contributing partner.

4550 Definition of Investment Company

IRC § 721(b) does not define an investment company. This section of the Code refers to IRC § 351.

The following are the **most crucial** points when considering whether a partnership is an investment company. They include that:

- More than 80% of the value of the partnership's assets must be held for investment purposes and consist of stocks and securities, or interests in RICs and REITs. [IRC § 351(e)(1)(A), Treas. Reg. § 1.351-1(c)(1)(ii)];
- Cash and evidence of indebtedness are now treated as stocks and securities and included in 80% computation (for contributions after June 8, 1997) [IRC § 351(e)(1)(B)];
- The determination of whether the 80% threshold is met is made **immediately after the transfers have been made** to the partnership [Treas. Reg. § 1.351-1(c)(2)].

Example 1:
*In 1996, R contributes stock with a fair market value of $65,000 and a basis of $50,000 to a partnership in exchange for a partnership interest. Immediately **before** the transfer, the partnership owns the following assets:*

Asset	*Value*
Cash	*$10,000*
Stocks	*$50,000*

Land	*$25,000*
Total	*$85,000*

*After R's contribution, the partnership owns $115,000 worth of stock and $150,000 worth of assets total. The partnership is **not** considered an investment company before R is admitted because the value of the stock ($50,000) does not exceed 80% of the value of all partnership assets other than cash ($85,000 less 10,000 = $75,000). After R's contribution, the partnership becomes an investment company because the value of the stocks ($115,000) exceeds 80% of the value of all partnership assets other than cash ($140,000). Therefore, R is required to recognize gain of $15,000 on the contribution of stock to the partnership.*

Although IRC § 721(b) is intended to prevent tax-free diversification of securities portfolios, it requires recognition of gain upon the contribution of property other than securities to a partnership investment company. [Senate Report N. 938, 94th Congress.,2d Session, pt. 2 at 43 (1976)]

In determining whether the partnership assets are held for investment purposes, the same intent principals used in determining whether a taxpayer held property as a capital asset apply. [Treas. Reg. § 1.351-1(c)(3)] The purpose for which it is held by the partnership is controlling. A partnership operating as a securities dealer cannot be treated as an investment company.

The 80% test cannot be avoided by tiered partnerships. (See example below)

- A parent partnership may be classified as an investment company even though its only asset is an interest in another partnership; if the subsidiary partnership owns readily marketable securities, the ownership of the securities is attributable to the parent partnership. [Treas. Reg. § 1.351-1(c)(4)]
- If the parent partnership owns 50% or more of the subsidiary partnership, the parent partnership will be deemed to own a ratable share of the subsidiary's marketable stocks and securities. [Treas. Reg. § 1.351-1(c)(4)]
- The share of the subsidiary's marketable investments allocated to the parent partnership is equal to the portion of the parent partnership's ownership in the subsidiary. The value of the partnership interest is not included in the computation.

Example 2:

The AB Partners is a partnership whose only asset is a 75% interest in CD Partners. CD Partners owns $2 million worth of publicly traded stocks. B, a partner in AB, transfers $200,000 worth of publicly traded stocks with a basis of $50,000 to AB Partners in exchange for an interest in the partnership. For purposes of the 80% test, the $1,500,000 value of AB Partners' interest in CD is disregarded. Alternately, AB Partners is treated as owning $1,500,000 (75% x $2,000,000) of marketable securities owned by CD Partners. Immediately after receiving B's contribution, AB is treated as owning $1,700,000 (1,500,000 + 200,000) of marketable securities. Since these are the only assets held by AB, they exceed the 80% threshold and the partnership is classified as an investment company.

***Observation**: Classification as an investment company can be easily avoided by falling below the 80% threshold. There are several other concerns that may be addressed if no gain or loss is recognized upon the transfer. The partners must remember that all precontribution gains and losses are allocated to the contributing partner. [IRC § 704(c)(1)(A)] A subsequent distribution of an asset received by the partnership as a contribution may result in the recognition of gain or loss. [IRC § 704(c)(1)(B) and § 737]*

***Note:** The 80% test is normally applied immediately after the assets are transferred to the partnership. [Treas. Reg. § 1.351-1(c)(2)] The regulations apply an "integrated" plan rule to the term "immediately after". If several investors transfer marketable securities at alternate points in time, the transfer may be viewed as part of an integrated plan, in which the 80% measurement will not be applied until after the last contribution occurs and will include all earlier contributions. [Comm. v Ashland Oil and Refining Co., 99F.2d 588 (6th Circuit. 1938)]*

4560 Diversification Requirement

IRC § 721(b) is not applicable unless there was a "diversification" of the transferor's investment portfolio for the transfer to result in the recognition of gain. [Treas. Reg. § 1.351-1(c)(1)(i)]

Diversification generally occurs if other investors transfer different assets to the same partnership. [Treas. Reg. § 1.351-1(c)(5); Rev. Ruling 87-9] (See Example below)

If two or more investors transfer identical assets to a newly organized partnership, the pooling generally does not result in a diversification. [Treas. Reg. § 1.351-1(c)(5); Rev. Ruling 88-32]

An insignificant element is disregarded under the de minimis rules. [Treas. Reg. § 1.351-1(c)(5)]

A transfer of stocks and securities will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of stocks and securities. [Treas. Reg. § 1.351-1(c)(6).] For this purpose, a portfolio of stocks and securities is diversified if it satisfies the 25 and 50-percent tests of IRC § 368(a)(2)(F)(ii), applying the relevant provisions of IRC § 368(a)(2)(F). Government securities are included in total assets for purposes of the denominator of the 25 and 50-percent tests (unless the Government securities are acquired to meet the 25 and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator.

The effect of diversification can be negated if:

- Each transferor is allocated all of the income and gains (or losses) from the assets the partner contributed, and
- Upon withdrawal from the partnership, the withdrawing partner is returned the property originally contributed.

Example 1:
S and D form an equal partnership. S contributes $50,000 worth of stock in X Corporation to the partnership, and D contributes $50,000 worth of stock in Y Corporation to the partnership. The newly formed partnership is a partnership investment company and diversification has occurred for both S and D.

Example 2:
R, D and C form a three-person partnership. R and D each contribute $49,500 worth of stock in X Corp for 49.5% interests in the partnership. C contributes $1,000 worth of stock in Y Corp for a 1% interest in the partnership. In determining whether diversification has occurred, C's contribution is disregarded. Therefore, no diversification is has occurred and no gain or loss is recognized. [Treas. Reg. § 1.351-1(c)(7) Example (1)]

4600 PARTNERSHIP'S BASIS OF CONTRIBUTED PROPERTY

PTM 4610 Basis of Contributed Property – General
PTM 4620 Basis of Personal Property Contributed

4610 Basis of Contributed Property – General

A partnership's basis in property contributed by a partner is equal to the adjusted basis of the contributing partner in the asset contributed at the time of contribution. [IRC § 723]

If a gain is recognized by the partner on account of a contribution of appreciated property to an investment partnership, then the amount of the partner's recognized gain is added to the partnership's basis in the property. [IRC § 723]

Example:
J and T form a partnership. In exchange for a 50% interest in capital and profits, J contributes undeveloped land with a fair market value of $2,000 and an adjusted basis of $500. T contributes $2,000 in cash for the other 50% interest. In accordance with IRC § 721(a), neither the partner, nor the partnership recognizes any gain as a result of the contributions. Under IRC § 722, J's basis in his partnership interest is $500, which is the adjusted basis of land that J contributed. T's basis in the partnership interest is $2,000, which is equal to the amount of money J contributed. The partnership's basis in the property is $500. If the partnership subsequently sells the property for $2,000, it will realize a gain of $1,500 that will be allocated to J under IRC § 704(c).

4620 Basis of Personal Property Contributed

If a partner contributes personal use property to a partnership that will be used by the partnership for business use, the partnership's basis for the property for the purposes of determining gain or loss is the lesser of its value at the time of the contribution or its adjusted basis in the contributing partner's hands. It is unclear whether the contributing partner's basis in his partnership interest is equal to the same amount.

- This special rule is an application of the general rules governing the conversion of personal assets to business use assets. [Treas. Reg. §§ 1.165-9(b), 1.167(g)-1]
- This basis rule prevents an individual who owns a personal use asset with a built in loss from being able to deduct the loss by converting the personal use property to business use.

- The special basis rule applies only for losses and depreciation purposes; therefore, the partnership may have to maintain a second basis for the asset to determine the amount of any gain realized on the sale of the asset.

Example:
B owns a truck that was used exclusively for personal purposes. B originally paid $25,000 for this truck. After using the truck for 2 years, B contributes it to a partnership in exchange for a partnership interest. At the time of the contribution, the truck was worth $15,000. B's adjusted basis in the truck was $25,000 since depreciation is not allowed for personal use assets. For depreciation purposes, the basis of the truck is $15,000.

The partnership uses the truck in its business and takes a $2,600 depreciation deduction for that year. The partnership sells the truck after the first year for $10,000. The partnership's adjusted basis in the truck is $12,400 ($15,000 fair market value less 2,600 depreciation). The loss on the sale of the truck is limited to $2,400 ($10,000 sales price less 12,400 adjusted basis).

Assume that instead of selling the truck for $10,000, the partnership sells the truck for $16,000 at the end of the first year. Since the adjusted basis of $12,400 is used only if there is a loss, the partnerships adjusted basis for determining the gain is $22,400 ($25,000 original cost less 2,600 depreciation). Therefore, the partnership realizes no gain or loss. [Treas. Reg. § 1.1015-1(a)(2) Example]

4700 HOLDING PERIODS

PTM 4710 Holding Period of Interest: Capital Assets or § 1231 Property
PTM 4720 Holding Period of Interest: Other Property

4710 Holding Period of Interest: Capital Assets or § 1231 Property

If a partnership interest is acquired in exchange for a contribution of property that is a capital asset or depreciable property used in the contributor's trade or business, the holding period of the partnership interest includes the contributor's holding period for the contributed property. [IRC § 1223(1)]

Example:
Partner Q contributes a land that was held as a capital asset to Partnership P. Q held the property for 3 years prior to the contribution. Q's holding period after the contribution for his partnership interest is 3 years.

Under IRC § 1223(2), a partnership's holding period for a contributed asset includes the holding period of the asset in the hands of the contributing partner.

4720 Holding Period of Interest: Other property

If a partner contributes cash or non-capital, non-IRC § 1231 assets in exchange for an interest in a partnership, the holding period of the interest begins on the date the partnership interest is acquired. [Treas. Reg. § 1.1223-1(a)]

Example:
P contributes inventory in exchange for an interest in Q Partnership. P held the inventory for four months prior to contributing it to Q. After the contribution of property to Q, P's holding period of the interest begins on the day the interest is acquired.