

DISGUISED SALE PLANNING

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October 10, 2022

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1.01 TAX PLANNING FOR THE EXTRACTION OF EQUITY

A partnership is often chosen over other structures as the tax entity best suited for the conduct of a business. However, there are a series of rules that can result in inadvertent gain recognition that need to be understood and considered. In addition, when taxpayers seek to dispose of or monetize their interest in the business, consideration of various rules that could accelerate gain recognition is critical. The areas of the tax law to be considered, include the following:

- [1] The partnership disguised sales rules.
- [2] The anti-mixing bowl rules of Section 704(c)(1)(B).
- [3] The anti-mixing bowl rules of Section 737.
- [4] The partnership liability allocation rules.

1.02 THE PARTNERSHIP DISGUISED SALE RULES

[1] Background

Contributions of property to and distributions of property from a partnership generally are not taxable to either the partnership or its partners. Sections 721 and 731.

Prior to the enactment of section 707(a)(2) in 1984, taxpayers recognized that by combining a contribution of property with a distribution of cash to the contributing partner, the economic substance of a sale could be achieved without current taxation to the seller/contributing partner, provided the form of the transaction was respected.

Conversely, if the seller/contributing partner received allocations of partnership taxable income under section 704(b), the remaining partners could achieve the effect of a deduction for the purchase price of the property.

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Longstanding regulations under sections 721 and 731 stated that a contribution of property followed by a distribution would be taxed as a sale if that was the economic substance of the transaction. Treas. Reg. §§ 1.731-1(c)(3), 1.721-1(a). Nevertheless, taxpayers enjoyed considerable success in litigating disguised sale cases, and a number of court decisions treated contribution/distribution transactions that arguably were similar to sales as tax-free transactions. See *Jupiter v. United States*, 2 Cl. Ct. 58 (1983); *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980); *Otey v. Commissioner*, 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (6th Cir. 1980).

Section 707(a)(2) was enacted as part of the Tax Reform Act of 1984. P.L. 98-369. Section 707(a)(2)(A) provides that, under regulations prescribed by the Secretary, if a partner performs services for or transfers property to a partnership, and there is a related allocation of income and distribution of cash or property to such partner, then the transaction will be treated as a transaction between the partnership and a person who is not a partner if, under all the facts and circumstances, the transaction is more properly characterized as a payment to a partner acting in a nonpartner capacity.

Section 707(a)(2)(B) provides that, under regulations prescribed by the secretary, if:

- (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
- (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
- (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

such transfers shall be treated either as a transaction occurring between the partnership and one who is not a partner or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

Regulations were proposed on April 24, 1991 and finalized, with modifications, on September 25, 1992. The regulations do not contain any examples involving section 707(a)(2)(A) transactions. The regulations have reserved a section to deal with disguised payments for services, Treas. Reg. § 1.707-2, and disguised sales of partnership interests, Treas. Reg. § 1.707-7. Regulations were further proposed and finalized on October 5, 2016 and October 9, 2019 to address certain additional disguised sale issues.

[2] Identifying Disguised Sales

[a] Facts and Circumstances Test

Under the regulations, a partner's transfer of property to a partnership and the partnership's transfer of money or other consideration to the partner constitute a sale of the property, in whole or in part, by the partner to the partnership only if, based on all the facts and circumstances, "(i) the transfer of money or other consideration would not have been made but

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