PacificCPE

Related Party and Disguised Sales

Course #33201C

Taxes

2 Credit Hours

Support@PacificCPE.com | (800) 787-5313

PacificCPE.com

PARTNERSHIPS AND LLCS: RELATED PARTY AND DISGUISED SALES

This course examines the tax treatment of disguised sales and related party transactions in partnerships. It covers key provisions of Code Sections 707, 704(c)(1)(B), and 737, focusing on when contributions and distributions may be treated as taxable sales. Topics include preferred returns, qualified liabilities, gain recognition rules, and the factors that determine disguised sale status. The course provides practical examples and guidance for navigating these complex partnership tax issues.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Related Party and Disguised Sales

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Recall the factors considered to determine whether a disguised sale took place.

Program publication date **9/23/25**

EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.
- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.
- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.
- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.
- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

TABLE OF CONTENTS

RELATED PARTY AND DISGUISED SALES

Objective

After completing, you should be able to:

- Recall the factors considered to determine whether a disguised sale took place.

¶101 INTRODUCTION

In keeping with the tension between the entity and aggregate conceptual framework for partnership taxation, transfers between the partnership and the partner are subject to rules that recognize the partnership as an entity separate from the partner, but take into account the fact that the partner is to some extent dealing with him- or herself. This course discusses the tax treatment of actual and deemed sales between the partnership and partner.

¶102 TAX TREATMENT OF SALE OF PROPERTY TO THE PARTNERSHIP BY A PARTNER

.01 Sale at a Gain

If any person considered to be related to the partnership, whether a partner or not, sells property to the partnership that does not qualify as a capital asset in the *partnership's* hands, the gain will be treated as ordinary income.[1] The same result occurs when the sale is by the partnership to the related party. Examples of property commonly affected by this provision are depreciable realty and subdivided real estate that will be developed and sold to the public. The purpose of this provision is to make sure partners/partnerships cannot avoid ordinary income by having a separate partnership/partner develop the property that is contributed/ distributed.

Persons are considered to be related to the partnership if they own, directly or indirectly, more than 50% of the partnership's profit or capital interests. A person is considered to indirectly own partnership interests if those interests are owned by the following other persons:

- Brothers;
- Sisters;
- Spouse;
- Ancestors; or
- Lineal descendants.[2]

1. Code Sec. 707(b)(2).
2. Code Secs. 707(b)(3) and 267(c).

A partnership interest held by a corporation, partnership, estate, or trust is considered to be owned proportionately by, or for, its shareholders, partners, or beneficiaries.[3]

.02 Sale at a Loss

No loss may be recognized on the sale of property between a partnership and a person owning, directly or indirectly, more than 50% of the interest in capital or profits of the partnership.[4] Indirect ownership is defined under Code Sec. 267(c) as described above.[5] Following the structure of Code Sec. 267, the buyer of property in this situation takes a cost basis equal to the price paid to acquire the property even though the loss realized by the seller is not recognized.

However, when the buyer subsequently disposes of the property, any gain realized in that transaction may be offset by the disallowed loss previously realized by the seller. The gain offset should be treated as tax exempt income for purposes of adjusting the basis of the partnership interest of the partners to whom the gain is allocated. If the disallowed loss exceeds the subsequently realized gain (or if there is no gain subsequently realized on disposition), the excess loss is permanently erased.

Example 1-1

EXAMPLE

Hilary Martin owns 60% of the capital and profits interests in Marlow Partners. This year, her son, Steve, sold property to the partnership for its appraised value of $275,000. Steve's tax basis in the property was $315,000. Because he is deemed to own the 60% interest in the partnership owned by Hilary, his $40,000 loss is disallowed under Code Sec. 707(b)(1). However, the partnership's tax basis in the property will be equal to the $275,000 price it paid. If it subsequently sells the property for, say, $325,000, it will report gain of only $10,000 (its $50,000 realized gain offset by Steve's $40,000 disallowed loss). Note that if it later sells the property for only $300,000, it will report no gain or loss. Its $25,000 realized gain will be offset by the previously disallowed loss, but no deduction will be allowed for the remaining, "unused" loss.

3. Code Secs. 707(b)(3) and 267(c)(1).

4. Code Sec. 707(b)(1). Losses are also disallowed on the sale of property between two partnerships if the same persons own (directly or indirectly) more than 50% of the profits or capital interests in the two partnerships.

5. For this purpose, Code Sec. 707(b)(3) provides for the application of Code Sec. 267(c), "other than paragraph (3) of such section."

Observation

A question remaining unanswered is whether the partner who had the burden of the disallowed loss can be specially allocated the benefit of the offset to the partnership's taxable income. Although the situation is very much like a built-in Code Sec. 704(c) loss, neither the Code Sec. 704(b) or (c) regulations address the issue. Note, however, that a special allocation of the loss will reduce the recipient's 704(b) capital account, ensuring that she will receive less upon liquidation than would otherwise have been the case. So long as the partnership properly accounts for the special allocation in the partner's capital account, there is no reason for the Service to disregard the allocation.

It should be noted that a sale of property at a loss between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately.[6] This means that even if the other person is not related to the partnership, part of the loss, as opposed to the whole loss, will be disallowed if the other person is related to one of the partners.

Example 1-2

A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. Partners *B* and *C* are not related to partner *A* or M Corporation. During the year the partnership sold property to M Corporation, sustaining a loss on the sale. The sale is considered as occurring between M Corporation and the partners separately. The sale considered as occurring between *A* and the M Corporation falls within the scope of Code Sec. 267(a) and (b), but the sales considered as occurring between partners *B* and *C* and the M Corporation do not. The latter two partners may, therefore, deduct their distributive shares of the partnership loss. However, no deduction will be allowed to *A* for his 1/3 distributive share of the partnership loss. Furthermore, *A's* adjusted basis for his partnership interest (and his capital account) must be decreased by the amount of his distributive share of the loss.[7] Note that M Corporation will be allowed to offset any future gain on disposition of this property by *A's* disallowed share of the loss.

Likewise, if M Corporation sold property to ABC for a loss, then only 2/3 of the loss (the part that was not "sold" to *A*) would be deductible by M Corporation.[8]

.03 S Corporation Comparison

Code Sec. 707 applies to partnerships only; it is not applicable to S corporations and it has no corollary in subchapter S. As a result, a shareholder can sell capital gain or Code Sec. 1231 property to an S corporation in which she owns stock and her gain will not be recharacterized as ordinary income regardless of the character of such property to the S corporation.

6. Reg. § 1.267(b)-1(b)(1).
7. Reg. § 1.267(b)-1(b)(2), Example 1.
8. Reg. § 1.267(b)-1(b)(2), Example 2.