PacificCPE

COURSE

33201D

Partnership Taxation: Related Party Transactions and Disguised Sales

Related party transactions and disguised sales are among the most scrutinized areas in partnership taxation. This course breaks down the rules that recharacterize what might look like a contribution or distribution into a taxable sale, and highlights key planning considerations for S corporations operating in related party contexts. If you work with partnerships or LLCs that have transactions between owners or affiliated entities, this is essential material for staying compliant and identifying planning opportunities.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

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

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TABLE OF CONTENTS

CHAPTER 01

Related Party And Disguised Sales 4

1.01 101 Introduction 4

1.02 .01 In General 7

1.03 .06 Disguised Payment For Services 27

1.04 Tax Planning Point 31

1.05 .03 Basis Rules 31

1.06 .01 Mechanics 37

1.07 .06 Hierarchy Of Statutes 39

Test Your Knowledge 49

Final Exam Copy 57

Glossary 55

Index .....

Chapter 1: RELATED PARTY AND DISGUISED SALES

Chapter Objective

After completing this chapter, 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 chapter 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 [1] as ordinary income. 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.

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

.02 Sale at a Loss

No loss may be recognized on the sale of property between a partnership and a person owning, directly [4] or indirectly, more than 50% of the interest in capital or profits of the partnership. Indirect ownership [5] is defined under Code Sec. 267(c) as described above. 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

Hilary Martin owns 60% of the capital and profits interests in Marlow Partners. This year, herson, 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.

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 [6] separately. 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 Band Care not relatedto partner Aor MC orporation. Duringthe year the partnership sold property to M Corporation, sustaining a loss on the sale. The sale is considered asoccurring between MC orporation 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 [7] of his distributive share of the loss. 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 [8] part that was not "sold" to A) would be deductible by M Corporation.

.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.

In contrast, Code Sec. 267 applies to both partnerships and S corporations. It denies the deductibility of losses realized on the sale of property by an S corporation to a shareholder owning more than 50%, directly or indirectly, of the S corporation's stock. The reverse is also true—no loss may be recognized by a shareholder on the sale of property to an S corporation in which she owns, directly or indirectly, [9] more than 50% of the outstanding stock. As in the partnership context, the disallowed loss may be used by the buyer to offset any gain recognized on a subsequent sale of the property.

103 PROPERTY CONTRIBUTIONS TREATED AS DISGUISED SALES

.01 In General

The traditional method of tax accounting for property transfers between the partnership and a partner allowed the parties to treat the transfers as separate transactions: a contribution of property to the partnership and a subsequent distribution of property from the partnership. The partner and the partnership could take the position that a bona fide contribution and an unrelated distribution had occurred minimizing the tax consequences associated with what is, in substance, a disguised sale between the partner and the partnership.

The IRS was left the difficult task of detecting the "plan" and proving that the transactions taken as a whole amounted to a sale. These disguised sales could take the form of cash sales when funds were "distributed" soon after a property "contribution." The sale could also be made in exchange for other property. For example, a taxpayer could contribute property A to a partnership and receive property B as a distribution in liquidation of his interest. Or, property A could be distributed to another partner in liquidation of his interest, leaving the partnership with only property B as its principal asset and the taxpayer as its principal partner.

Under the traditional contribution and distribution rules of partnership taxation, the swap would be tax- free. Three provisions have been enacted to treat these types of transactions as disguised sales: Code Secs. 707(a)(2)(B), 704(c)(1)(B), and 737.

S Corporation Observation

There is no counterpart to the partnership disguised sale rules in subchapter S. However, the potential for abuse is much lower due to the very different rules applicable to distributions from an S Corp to its shareholders. If a shareholder receives any property other than stock in exchange for a contribution of property to a regular or S corporation, such property is treated as “boot” and generates immediate tax consequences. Distributions to a shareholder subsequent to the contribution of property to the S corporation must generally be pro rata unless they are structured as a stock redemption. Stock redemptions are treated by the shareholder as a sale of his or her stock, triggering immediate tax consequences. In addition, distributions of appreciated property are a taxable event to an S or C corporation.

.02 Contributions Related to Distributions—The Facts and Circumstances Test of

Code Sec. 707(a)(2)(B) Code Sec. 707(a)(2)(B) deals with disguised sales carried out by means of a contribution to the partnership entity followed by a subsequent distribution to the partner by re-characterizing the two transactions as a deemed sale between the partner and the partnership. The “disguised sale between partners” technique demonstrated in the examples below was used by taxpayers in a number of reported [11] cases.

Example 1-3

A owns land with a $100,000 fair market value and basis of $60,000. B is interested in developing the land but A does not want to recognize taxable gain from sale of the land. Theyforman equal partnership in which Acontributesthel and and Bcontributes $50,000 and a financing commitment. After the money is obtained to finance the development, the partnership distributes $50,000 of cash to A. Since A’s basis is $60,000, A recognizes no gain on the transaction. This is true even though in the IRS’s view A has, in essence, sold a half interest in this property to B, which should have resulted in a gain of $20,000. A would be effectively using his entire basis in the land to offset a gain on the sale of one-half the land.

Example 1-4

A owns land with a $100,000 fair market value and a basis of $60,000. The BC partnership is interested in developing the land and A is willing to sell it for BC's installment note. Under the installment method of reporting this sale, A's reporting ratio would be60%and Awould report60%of each paymentas capital gain. BC instead arranged the sale as a contribution to the renamed ABC partnership followed by an installment liquidation of A's interest. Under the partnership distribution rules, cash distributions are first treated as recoveries of A's $60,000 basis in his interest before [12] he reports any capital gain. A would in effect be receiving cost recovery reporting for the installment sale.

Prior to implementation of Code Sec. 707(a)(2)(B), the IRS was explicitly authorized in the regulations under Code Sec. 731 to re-characterize as sales contributions which were followed by related distributions. The IRS argued that the substance of such transactions was a sale and that the tax treatment should correspond to the substance. The courts, however, often held that taxpayers had simply structured a transaction to achieve favorable tax results. The cases hinged on the importance of the particular property to the business of the partnership and the necessity of financial success before the partner contributing property could recover his or her entire investment. As an example, in Otey v. [14] Commissioner, the Tax Court pointed out that, without the contributed property, the partnership would have no property at all, and Otey had no guarantee of recovering his property's value from a buyer. Code Sec. 707(a)(2)(B) now states, as did the prior regulations, that when such a transaction, viewed as a whole, is properly characterized as a sale, then the transaction is treated as a sale and governed by [15] Code Sec. 707(a)(1).

General rules. The general rules provide that a transfer of property to a partnership, coupled with a concurrent or subsequent transfer of money or other consideration to the contributing partner (including the assumption of the partner's liability or taking the property subject to the liability), will be treated, not as two separate transactions, but as a sale, in whole or in part, of the property to the partnership if:

1. The transfer of money or other consideration would not have been made but for the transfer of property; and
2. In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. [16]

Similar rules apply when the transfer of property by one or more partners to a partnership is associated with a distribution to another partner in liquidation of her partnership interest. In such cases, the liquidating partner is treated as selling her interest in the partnership. Such a deemed sale will be fully taxable, whereas a liquidating distribution is generally not taxable, or at least not fully taxable. [17]

The regulations adopt a test of ten facts and circumstances to determine whether either of the foregoing two rules applies. [18]

The facts and circumstances taken into account in determining whether a disguised sale has occurred are:

1. The reciprocal transfer's timing and amount are determinable with reasonable certainty;

2. The partner has a legally enforceable right to the reciprocal transfer;

3. The right to the reciprocal transfer is secured;

4. Another party is legally obligated to make contributions to the partnership to permit the partnership to make the reciprocal transfer;

5. Another party is legally obligated to loan money to the partnership to permit the partnership to make the reciprocal transfer;

6. The partnership is obligated to borrow amounts necessary to permit the reciprocal transfer;

7. The partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the reciprocal transfer;

8. The partnership distributions, allocations, or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

9. Transfers of money or other consideration by the partnership to the partner that are disproportionately large in relationship to the partner's general and continuing interest in partnership profits indicates a reciprocal transfer; and [19]

10. A distribution that is in no event returnable indicates a reciprocal transfer.

Presumptions. If within two years of a property contribution to a partnership the partnership transfers money or other property to the partner, the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a [20] sale. With certain exceptions, the regulations require tax return disclosure of any distributions to