DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8439]

RIN 1545–AH22

Treatment of Transactions Between Partners and Partnerships; Correction

AGENCY: Internal Revenue Service, Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains corrections to the final regulations (T.D. 8439), which were published Wednesday, September 30, 1992 (57 FR 44974). The final regulations relate to the treatment of transactions between partners and partnerships and, in some instances between partners themselves under section 707 of the Internal Revenue Code.

EFFECTIVE DATE: September 30, 1992.

FOR FURTHER INFORMATION CONTACT: Susan Edlavitch or J. Scott Hargis at (202) 622–3050 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of these corrections add new regulations § 1.707–0 and §§ 1.707–2 through 1.707–9 to the Income Tax Regulations (26 CFR part 1) under section 707(a)(2) of the Internal Revenue Code.

Need for Correction

As published, the final regulations contain errors which may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the final regulations (T.D. 8439), which were the subject of FR Doc. 92–23728, is corrected as follows:

§ 1.707–4 [Corrected]

Paragraph 1. On page 44982, column one, in § 1.707–4, paragraph (a)(3)(ii), last line of that column, the language "percent of the highest applicable federal" is corrected to read "percent of the highest applicable Federal".

Par. 2. On page 44982, column two, in § 1.707–4, paragraph (a)(4), paragraph (i) of *Example 1*, third line from the bottom of the paragraph, the language "applicable federal rate in effect at the time of" is corrected to read "applicable Federal rate in effect at the time of".

Par. 3. On page 44982, column 3, in § 1.707–4, paragraph (a)(4), paragraph (ii) of *Example 2*, third line from the bottom of the paragraph, the language "federal rate in effect at the time the" is corrected to read "Federal rate in effect at the time the".

Dale D. Goode,

Federal Register Liaison Officer, Assistant Chief Counsel (Corporate).

[FR Doc. 92–28854 Filed 11–27–92; 8:45 am]

BILLING CODE 4830-01-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8439]

RIN 1545-AH22

Treatment of Transactions Between Partners and Partnerships

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the treatment of transactions between partners and partnerships and, in some instances, between partners themselves, under section 707 of the Internal Revenue Code. Changes to the applicable law were made by the Tax Reform Act of 1984. The final regulations affect partnerships and their partners, and are necessary to provide them with guidance needed to comply with the applicable tax law.

DATES: These regulations are effective April 24, 1991, and apply to transactions with respect to which all transfers considered part of a sale occur after April 24, 1991.

FOR FURTHER INFORMATION CONTACT: Susan T. Edlavitch or J. Scott Hargis at (202) 622-3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information requirement contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under control number 1545-1243. The estimated annual burden per respondent varies from 15 minutes to 25 minutes, depending on individual circumstances, with an estimated average of 20 minutes.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224 and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Introduction

This document adds new regulations § 1.707-0 and §§ 1.707-2 through 1.707-9 to the Income Tax Regulations (26 CFR part 1) under section 707(a)(2) of the Internal Revenue Code (the Code). No change is made to existing § 1.707-1.

Background

On April 25, 1991, a notice of proposed rulemaking relating to the treatment of transactions between partners and partnerships was published in the Federal Register (56 FR 19055). Written comments were received and a public hearing was held on September 23, 1991. After full consideration of the comments and the statements made at the public hearing, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

I. Enactment of Section 707(a)(2)

Section 707(a)(2)(B) of the Code grants the Secretary broad regulatory authority to identify those transactions that, though structured as contributions and distributions under sections 721 and 731, are more properly treated under section 707(a) as sales or exchanges between a partnership and a partner acting in a capacity other than as a member of the partnership. Section 707(a)(2)(A), in relevant part, grants broad regulatory authority to treat a transfer of property by a partner to a partnership and a related direct or indirect allocation and distribution to the partner as a sale or exchange if the transfers are properly viewed together as occurring between a partnership and a partner acting in a capacity other than as a partner. The final regulations apply to contributions and distributions described in section 707(a)(2)(A) and transfers described in section 707(a)(2)(B) of the Code.

II. General Rules Regarding Disguised Sales to Partnership

A. Tax Consequences

The final and proposed regulations provide that if a contribution and related distribution are treated as a disguised sale, the contribution and distribution will be treated as a sale or exchange between the partnership and a person acting in a capacity other than as a member of the partnership for all purposes of the Code. Moreover, if the consideration treated as transferred to a partner pursuant to a sale is less than the fair market value of the property transferred to the partnership, the transfer will be treated as a sale in part and a contribution in part.

In the case of non-simultaneous transfers, comments proposed that, absent a contractual or legal obligation to make the subsequent transfer, the disguised sale recharacterization should be deemed to occur at the time of the subsequent transfer. Careful consideration was given to various alternatives for implementing a later sale approach. The theoretical basis of the approach of the proposed regulations, however, is more consistent with disguised sale principles and the legislative directive to prevent taxpayers from inappropriately deferring or avoiding tax on the sale of property. For example, any later sale approach would most likely generate a different amount of gain than that inherent in the property at the date of the original transfer. See H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1218, 1220 (1984) (H.R. Rep.); S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess. 224-25, 230 (1984) (S. Prt.).

In addition, any later sale approach would require complex rules and operate in a complex manner. The complexity of any later sale approach stems from the difficulty of determining the value of the transferred property and the basis attributable to that property on the later date. Each of the suggested later sale approaches addressed this difficulty by adopting some recharacterization of the subsequent transfer. The recharacterizations considered were to treat the subsequent transfer as (1) a partial redemption of the partner's interest in the partnership on the later date, (2) a deemed distribution of property on the later date, or (3) a sale of some or all of the partnership interest to the other partners on the later date. If any of these approaches were adopted, rules would have to be provided to coordinate with the other provisions of subchapter K, including the distribution provisions of section 731 and section 733, the basis adjustment provisions of section 734, and the provisions relating to disproportionate distributions of section 751 assets.

For these reasons, the final regulations retain the rules of the proposed regulations relating to non-simultaneous transfers. Accordingly, if a transfer to a partner that is part of a disguised sale occurs subsequent to the partner's transfer of property to the partnership, the partner will be treated as if he or she received an obligation of the partnership as consideration for the property on the date the partnership acquired ownership of the property.

Comments requested that the regulations detail the collateral tax consequences of disguised sale recharacterization. These regulations are intended to provide rules that determine when a disguised sale has taken place rather than to resolve in detail the varying tax issues arising from sale recharacterization. Since the tax principles and rules that generally apply to sales apply to transactions characterized as sales under these regulations, the Service and the Treasury believe that it is unnecessary to address the various collateral consequences in the final regulations. Collateral consequences will be addressed in subsequent guidance to the extent the Service deems appropriate.

Comments also questioned the absence of anti-abuse rules directed at specific situations, such as related party transactions. The Service and the Treasury believe that general tax principles adequately address these issues. Other comments questioned whether transfers caused by a termination of a partnership under section 708(b)(1)(B) could result in disguised sale treatment under these regulations. The final regulations clarify that such transfers are disregarded for purposes of the disguised sale rules.

B. Facts and Circumstances Test

The final regulations retain the facts and circumstances approach of the proposed regulations. In addition, the final regulations retain the list of factors that, among others, tend to indicate the existence of a disguised sale.

C. Presumptions Related to the Timing of Transfers

The final regulations follow the proposed regulations by providing that transfers between a partnership and a partner that are made within two years of each other are presumed to be a sale (unless one of the exceptions applicable to guaranteed payments for capital, reasonable preferred returns or operating cash flow distributions applies), and transfers made more than two years apart are presumed not to be a sale. Each of these presumptions may be rebutted only by facts and circumstances that clearly establish the contrary. The presumptions are intended to establish which party has the burden of going forward in litigation. In addition, the regulations require that the party against whom the presumption runs must clearly establish that the transaction is or is not a disguised sale as the case may be. Thus, a mere preponderance of evidence (the standard of persuasion that would apply in the absence of the clearly establish requirement) will not suffice.

D. Multiple Property Transfers

In response to comments, the rule contained in the proposed regulations requiring a partner contributing multiple properties to a partnership to allocate the amount realized among the properties based on their values has been deleted. Thus, the final regulations do not provide special rules for the allocation of amounts realized in these transactions.

E. Mixing Bowl Example

The proposed regulations contain an example showing that the Service can rebut the presumption for transfers more than two years apart where, among other facts, more than one partner contributes property to a partnership, the partnership agreement provides for cross-allocations with respect to the contributed properties, and one partner receives a liquidating distribution of the property contributed by the other partner. See Prop. Reg. § 1.707-3(g) *Example 8*. The final regulations retain the mixing bowl example without change, notwithstanding the submission of numerous comments requesting more specific guidance. See § 1.707-3(f) *Example 8*. The example was written to illustrate the facts and circumstances test. The Service and the Treasury emphasize that the example relies on a confluence of factors and is not intended to provide bright-line guidance or to indicate whether the result might change if one or more of the enumerated factors were changed or eliminated.

F. Other Examples

The final regulations provide minor clarification to some of the other examples in § 1.707-3(f), but without adding new facts that would alter the results stated in the proposed regulations.

III. Special Rules Applicable to Certain Distributions

The final regulations adopt, with certain modifications, the special rules applicable to guaranteed payments and preferred returns contained in the proposed regulations. In addition, the final regulations provide greater flexibility with respect to the rules applicable to operating cash flow distributions and reimbursements of preformation expenditures.

A. Guaranteed Payments for Capital

In many cases, a legitimate guaranteed payment for capital is not subject to the entrepreneurial risks of partnership operations and would be treated as part of a sale if the payment were tested under the general rules of § 1.707-3. Accordingly, the final regulations retain the rule of the proposed regulations that a legitimate guaranteed payment for capital is excepted from the general rule and is not treated as part of a sale of property.

Further, the proposed and final regulations provide that a transfer that is characterized by the parties as a guaranteed payment for capital and that is reasonable within the meaning of § 1.707-4(a)(3) will be presumed to be, in fact, a guaranteed payment for capital. A transfer that is characterized by the parties as a guaranteed payment for capital and that is not reasonable will be presumed not to be a guaranteed payment for capital. Each presumption can be rebutted only by facts and circumstances that clearly establish the contrary. If a transfer characterized by the parties as a guaranteed payment for capital is not respected as such, the transfer is subject to the general rules of the final regulations, including the presumptions for transfers made less than or more than two years apart. The final regulations do not provide explicitly that a distribution properly characterized as a guaranteed payment for services is not treated as part of a sale. Although distributions of this type are not specifically excepted from the regulations and are subject to any applicable presumption, guaranteed payments for services should not be considered part of a sale of property under the facts and circumstances test, because they are not related to a transfer of property by a partner. Similarly, a transfer of money that represents a bona fide loan or a transfer of money in repayment of a bona fide loan should not be considered part of a sale of property under the facts and circumstances test.

B. Reasonable Preferred Returns

The final regulations retain the rule of the proposed regulations that a transfer of money that is characterized by the parties as a preferred return and that is reasonable within the meaning of § 1.707-4(a)(3) is presumed not to be part of a sale unless the facts and circumstances clearly establish that the transfer is part of a sale.

C. Operating Cash Flow Distributions

The final regulations retain the rule that provides that transfers of money to a partner during a taxable year that do not exceed the partner's interest in net operating cash flow are presumed not to be part of a sale unless the facts and circumstances clearly establish that the transfers are part of a sale. For this purpose, a partner's interest in a net operating cash flow distribution is determined based on the lesser of the partner's percentage interest in overall partnership profits for the year or the partner's percentage interest in overall partnership profits for the life of the partnership. The final regulations also retain the safe harbor allowing a partner, in any taxable year of the partnership, to use the partner's smallest percentage interest in any material item of partnership income or gain that may be realized in the three-year period beginning with such taxable year.

D. Modifications Made by the Final Regulations to the Special Rules Applicable to Guaranteed Payments, Preferred Returns, and Operating Cash Flow Distributions.

In response to comments, the final regulations have modified the special rules for guaranteed payments, preferred returns, and operating cash flow distributions to provide greater flexibility in their application. Under the proposed and final regulations, a distribution that is characterized as a guaranteed payment for capital or a preferred return is reasonable if the distribution is made pursuant to a written provision of the partnership agreement and is reasonable in amount. The proposed regulations provide, generally, that a distribution is reasonable in amount if the sum of the guaranteed payment for capital and preferred return does not exceed the amount determined by multiplying the partner's unreturned capital balance at the beginning of the taxable year by a specified percentage. The final regulations modify the determination of whether a distribution is reasonable in amount by permitting the partner to choose to replace, in that calculation, its beginning-of-the-year unreturned capital balance with a weighted average capital balance for the year and by clarifying the rule's application where a guaranteed payment or preferred return is compounded more frequently than annually.

Comments also criticize *Example 2* of § 1.707-4(a)(4) of the proposed regulations which describes a distribution determined not to be a guaranteed payment for capital. The final regulations retain the example, but clarify that the non-contributing partner, D, funds entirely the guaranteed payment to C (i.e., is obligated to contribute any shortfall to the partnership necessary to make payment to the contributing partner, C, even in the event of a partnership liquidation). The example also clarifies that had the partnership (or D) purchased the property from C in an installment sale, a market rate of interest would have resulted in payments approximately equal to the guaranteed payments.

In further response to comments, the final regulations clarify the presumption regarding operating cash flow distributions. In determining the net cash flow of a partnership, the final regulations provide that the starting taxable income or loss figure is increased by tax exempt interest and is decreased by capital expenditures only when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow. If a transfer of operating cash flow exceeds the amount allowed under the operating cash flow presumption, the transfer will qualify for the presumption up to the amount allowed under the presumption. The excess or portion of the transfer that does not qualify as an operating cash flow distribution is tested under the facts and circumstances test, subject to any presumptions that may apply.

The final regulations also modify the proposed regulations to provide that accumulated guaranteed payments for capital, preferred returns, and operating cash flow distributions that meet the requirements for a favorable presumption remain subject to that favorable presumption if paid in subsequent years. As a result of this change, the rule of the proposed regulations regarding distributions within 75 days of year end is no longer necessary and has been deleted.

E. Reimbursement of Preformation Expenditures

The proposed regulations provide that transfers made to reimburse partners for certain capital expenditures incurred within one year prior to contributing property to a partnership are excepted from the rules of § 1.707-3(a) of the proposed regulations. The final regulations extend this exception to expenditures incurred within two years of the transfer by the partner to the partnership. The final regulations retain the proposed rule that reimbursements of capital expenditures are excepted from disguised sale treatment if they do not exceed 20 percent of the fair market value of the property. In the case of a reimbursement that exceeds 20 percent of the value, the final regulations allow the reimbursement to qualify for this exception to the extent of 20 percent of value. Under an alternative rule included in the final regulations, 100 percent of the reimbursements of capital expenditures are excepted from disguised sale treatment if the value of the property contributed by the partner does not exceed 120 percent of the partner's basis in the contributed property.

F. Discretion To Provide Other Exceptions

The final regulations provide that the Commissioner may by revenue ruling or other published guidance except other types of transfers or payments to a partner from treatment as part of a sale. This provision is intended to increase the Commissioner's ability to provide guidance that accommodates reasonable and customary business practices.

IV. Special Rules Relating to Liabilities

A. In General

The final regulations retain the proposed regulation's concept of debt incurred in anticipation of a transfer. Thus, the final regulations continue to distinguish between qualified and nonqualified liabilities. Under the proposed and final regulations, a partnership's assumption of (or taking subject to) a nonqualified liability is treated as part of a sale. In contrast, the assumption of (or taking subject to) a qualified liability is treated as part of a sale only to the extent the partner is otherwise treated as having sold a portion of the property.

The proposed regulations include in the definition of qualified liabilities certain liabilities incurred in the ordinary course of a trade or business in which the property transferred was used, but only if substantially all of the assets of the business are transferred. Comments questioned the necessity for, and application of, the requirement that substantially all of the assets of the business be contributed. The final regulations replace the substantially all requirement with a requirement that the partner must transfer to the partnership all the assets related to that trade or business other than assets that are not material to a continuation of the trade or business. See § 1.705-5(f) *Example 4*.

In response to comments, the final regulations clarify the definition of a qualified liability in two other respects. The final regulations clarify that a qualified liability need only encumber the transferred property throughout the two-year period prior to the transfer. The final regulations also provide that, consistent with section 7701(g), the fair market value limitation contained in § 1.707–5(a)(6)(ii) of the proposed regulations applies only with respect to recourse liabilities.

New examples have been added to § 1.707–5(f) to illustrate further the substantive rules.

B. Partner's Share of Liability

The final regulations adopt the proposed rule providing that a partner's share of a recourse liability equals the partner's share of the liability under section 752 and the corresponding regulations. The final regulations, however, depart from the proposed rule for determining a partner's share of a nonrecourse liability. The final regulations provide that a partner's share of a nonrecourse liability is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under section 1.752–3(a)(3) (the so-called third-tier allocation rule).

The final regulations change the proposed rule regarding a partner's share of a nonrecourse liability in response to comments and in an effort to achieve greater simplicity. The Service and the Treasury did not adopt the nonrecoruse debt allocation rules provided in section 752 and the regulations thereunder in their entirety, because this approach would tend to produce an inverse relationship between the gain inherent in the contributed property and the extent to which a disguised sale of the property results from the encumbrance.

C. Multiple Liabilities Assumed in Connection With a Plan

The proposed regulations allow the netting of nonqualified liabilities in connection with an integrated plan, but do not allow the netting of nonqualified liabilities with qualified liabilities. The comments criticized this limited netting rule as treating a transferor of appreciated property subject to a nonqualified liability less favorably if the co-transferor's property were encumbered with a qualified liability than if the co-transferor's property were encumbered with a nonqualified liability. In response, the final regulations expand the precontribution netting rule to allow the netting of nonqualified liabilities with qualified as well as nonqualified liabilities assumed or taken subject to in connection with an integrated transaction.

D. Refinancing

The proposed regulations provide that certain partnership debt incurred to refinance other partnership debt will be treated as that other debt. Comments suggested that a similar refinancing rule is needed in situations in which a partner refinances debt prior to a transfer to the partnership. In response to these comments, the final regulations provide that the same refinancing rule applies both to a refinancing by a partner prior to transfer of property to a partnership and to a refinancing of partnership debt.

E. Tiered Partnerships and Other Related Persons

The final regulations include a liability tacking rule for tiered partnerships. The final regulations clarify that if a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the same characterization as qualified or nonqualified that it had in the upper-tier partnership. Under the final regulations, the Commissioner may by guidance published in the Internal Revenue Bulletin provide that a similar rule applies in the case of transactions between other related parties.

V. Outbound Transactions Involving a Disguised Sale of Property by a Partnership to a Partner

Section 1.707–6 of the proposed and final regulations provide rules relating to disguised sales by a partnership to a partner. The rules are similar to the rules provided in §§ 1.707–3 and 1.707–5 for disguised sales by a partner to a partnership. However, the final regulations expand the definition of qualified liability in the context of outbound transactions, so that a partnership liability is qualified if it has been in existence for more than two years regardless of whether it has encumbered partnership property during that period.

VI. Disclosure

The proposed and final regulations provide that certain transactions are to be reported by partners and partnerships on Internal Revenue Service Form 8275 or on a statement attached to the partner's return. (Meeting the disclosure requirements of these final regulations does not necessarily satisfy the disclosure requirements of section 6662 of the Code and the regulations proposed thereunder (regarding the penalty for underpayment of tax), if that section is otherwise applicable.) The proposed regulations require disclosure in three situations. Because the final regulations modify the rules for allocation of nonrecourse liabilities, disclosure is no longer required in this situation. The final regulations thus require disclosure in only two situations: (1) When certain transfers to a partner are made within two years of a transfer of property by the partner to the partnership; and (2) when debt is incurred within two years of the earlier of a written agreement to transfer or of a transfer of the property that secures the debt, if the debt, nevertheless, is treated as a qualified liability. Similar disclosure rules are provided in the case of outbound transactions under § 1.707–6 of the final regulations. A further modification of the disclosure rules is contained in § 1.707–8(c) of the final regulations. The final regulations now permit disclosure by the partnership rather than by each transferor separately if more than one partner transfers property to a partnership pursuant to a plan.

VII. Effective Dates

The final regulations apply to transactions with respect to which all transfers considered part of a sale occur after April 24, 1991. However, pursuant to Notice 92–46 published in the Internal Revenue Bulletin, a partnership and its partners may apply the proposed regulations instead of the final regulations to any transaction with respect to which all transfers considered part of a sale occur after April 24, 1991, if at least one of the transfers considered part of a sale occurs before November 30, 1992. The final regulations state that a determination of disguised sale treatment for the period between the effective date of section 707(a)(2) of the Code and April 24, 1991, is to be made based on the statutory language and the guidance provided in the legislative history of section 707(a)(2).

Special Analyses

It has been determined that these regulations are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for these regulations was submitted to the Chief Counsel for Advocacy of the Small

Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these final regulations are David R. Haglund and Susan T. Edlavitch of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the Internal Revenue Service and the Treasury Department participated in their development.

List of Subjects

26 CFR 1.701-1 through 1.771-1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805 * * * Sections 1.707-2 through 1.707-9 also issued under 26 U.S.C. 707(a)(2). * * *

Par. 2. Section 1.707-0 and §§ 1.707-2 through 1.707-9 are added to read as follows:

§ 1.707-0 Table of contents.

This section lists the captions that appear in §§ 1.707-1 through 1.707-9.

§ 1.707-2 Disguised payments for services. [Reserved]

§ 1.707-3 Disguised sales of property to partnership; general rules.

(a) *Treatment of transfers as a sale*—(1) *In general.* Except as otherwise provided in this section, if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in paragraph (b)(1) of this section, the transfers are treated as a sale of property, in whole or in part, to the partnership.

(2) *Definition and timing of sale.* For purposes of §§ 1.707-3 through 1.707-5, the use of the term sale (or any variation of that word) to refer to a transfer of property by a partner to a partnership and a transfer of consideration by a partnership to a partner means a sale or exchange of that property, in whole or in part, to the partnership by the partner acting in a capacity other than as a member of the partnership, rather than a contribution and distribution to which sections 721 and 731, respectively, apply. A transfer that is treated as a sale under paragraph (a)(1) this section is treated as a sale for all purposes of the Internal Revenue Code (*e.g.*, sections 453, 483, 1001, 1012, 1031 and 1274). The sale is considered to take place on the date that, under general principles of Federal tax law, the partnership is considered the owner of the property. If

the transfer of money or other consideration from the partnership to the partner occurs after the transfer of property to the partnership; the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other consideration.

(3) *Application of disguised sale rules.* If a person purports to transfer property to a partnership in a capacity as a partner, the rules of this section apply for purposes of determining whether the property was transferred in a disguised sale, even if it is determined after the application of the rules of this section that such person is not a partner. If after the application of the rules of this section to a purported transfer of property to a partnership, it is determined that no partnership exists because the property was actually sold, or it is otherwise determined that the contributed property is not owned by the partnership for tax purposes, the transferor of the property is treated as having sold the property to the person (or persons) that acquired ownership of the property for tax purposes.

(4) *Deemed terminations under section 708.* In applying the rules of this section, transfers resulting from a termination of a partnership under section 708(b)(1)(B) are disregarded.

(b) *Transfers treated as a sale*—(1) *In general.* A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of 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 for the transfer of property; and

(ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

(2) *Facts and circumstances.* The determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, under paragraph (b)(1) of this section is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists under paragraph (b)(1) of this section. Among the facts and circumstances that may tend to prove the existence of a sale under paragraph (b)(1) of this section are the following:

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier 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 in any manner, taking into account the period during which it is 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 a partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that 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 (taking into account the income that will be earned from those assets);

(viii) That partnership distributions, allocation 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 other 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 that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

(c) *Transfers made within two years presumed to be a sale*—(1) *In general.* For purposes of this section, if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), 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 sale.

(2) *Disclosure of transfers made within two years.* Disclosure to the Internal Revenue Service in accordance with § 1.707–8 is required if—

(i) A partner transfers property to a partnership and the partnership transfers money or other consideration to the partner with a two-year period (without regard to the order of the transfers);

(ii) The partner treats the transfers other than as a sale for tax purposes; and

(iii) The transfer of money or other consideration to the partner is not presumed to be a guaranteed payment for capital under § 1.707–4(a)(1)(ii), is not a reasonable preferred return within the meaning of § 1.707–4(a)(3), and is not an operating cash flow distribution within the meaning of § 1.707–4(b)(2).

(d) *Transfers made more than two years apart presumed not to be a sale.* For purposes of this section, if a transfer of money or other consideration to a partner by a partnership and the transfer of property to the partnership by that partner are more than two years apart, the transfers are presumed not to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.

(e) *Scope.* This section and §§ 1.707–4 through 1.707–9 apply to contributions and distributions of property described in section 707(a)(2)(A) and transfers described in section 707(a)(2)(B) of the Internal Revenue Code.

(f) *Examples.* The following examples illustrate the application of this section.

Example 1. Treatment of simultaneous transfers as a sale. 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, under this section, the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Because the amount of cash A receives on April 9, 1992, does not equal the fair market value of the property, A is considered to have sold a portion of property

X with a value of $3,000,000 to the partnership in exchange for the cash. Accordingly, A must recognize $2,100,000 of gain ($3,000,000 amount realized less $900,000 adjusted tax basis ($1,200,000 multiplied by $3,000,000/$4,000,000)). Assuming A receives no other transfers that are treated as consideration for the sale of the property under this section, 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 tax basis of $300,000.

Example 2. Treatment of transfers at different times as a sale. (i) The facts are the same as in *Example 1*, except that the $3,000,000 is transferred to A one year after A's transfer of property X to the partnership. Assume that under this section the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Assume also that the applicable Federal short-term rate for April, 1992, is 10 percent, compounded semiannually.

(ii) Under paragraph (a)(2) of this section, A and the partnership are treated as if, on April 9, 1992, A sold a portion of property X to the partnership in exchange for an obligation to transfer $3,000,000 to A one year later. Section 1274 applies to this obligation because it does not bear interest and is payable more than six months after the date of the sale. As a result, A's amount realized from the receipt of the partnership's obligation will be the imputed principal amount of the partnership's obligation to transfer $3,000,000 to A, which equals $2,721,088 (the present value on April 9, 1992, of a $3,000,000 payment due one year later, determined using a discount rate of 10 percent, compounded semiannually). Therefore, A's amount realized from the receipt of the partnership's obligation is $2,721,088 (without regard to whether the sale is reported under the installment method). A is therefore considered to have sold only $2,721,088 of the fair market value of property X. The remainder of the $3,000,000 payment ($278,912) is characterized in accordance with the provisions of section 1272. Accordingly, A must recognize $1,904,761 of gain ($2,721,088 amount realized less $816,327 adjusted tax basis ($1,200,000 multiplied by $2,721,088/$4,000,000)) on the sale of property X to the partnership. The gain is reportable under the installment method of section 453 if the sale is otherwise eligible. Assuming A receives no other transfers that are treated as consideration for the sale of property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,278,912 of the fair market value of property X with an adjusted tax basis of $383,673.

Example 3. Operation of presumption for transfers within two years. (i) C transfers undeveloped land to the CD partnership in exchange for an interest in the partnership. The partnership intends to construct a building on the land. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of $500,000 and a fair market value of $1,000,000. The partnership agreement provides that upon completing construction of the building the partnership will distribute $900,000 to C.

(ii) If, within two years of C's transfer of land to the partnership, a transfer is made to C pursuant to the provision requiring a distribution upon completion of the building, the transfer is presumed to be, under paragraph (c) of this section, part of a sale of the land to the partnership. C may rebut the presumption that the transfer is part of a sale if the facts and circumstances clearly establish that—

(A) The transfer to C would have been made without regard to C's transfer of land to the partnership; or

(B) The partnership's obligation or ability to make this transfer to C depends, at the time of the transfer to the partnership, on the entrepreneurial risks of partnership operations.

(iii) For example, if the partnership will be able to fund the transfer of cash to C only to the extent that permanent loan proceeds exceed the cost of constructing the building, the fact that excess permanent loan proceeds will be available only if the cost to complete the building is significantly less than the amount projected by a reasonable budget would be evidence that the transfer to C is not part of a sale. Similarly, a condition that limits the amount of the permanent loan to the cost of constructing the building (and thereby limits the partnership's ability to make a transfer to C) unless all or a substantial portion of the building is leased would be evidence that the transfer to C is not part of a sale, if a significant risk exists that the partnership may not be able to lease the building to that extent. Another factor that may prove that the transfer of cash to C is not part of a sale would be that, at the time the land is transferred to the partnership, no lender has committed to make a permanent loan to fund the transfer of cash to C.

(iv) Facts indicating that the transfer of cash to C is not part of a sale, however, may be offset by other factors. An offsetting factor to restrictions on the permanent loan proceeds may be that the permanent loan is to be a recourse loan and certain conditions to the loan are likely to be waived by the lender because of the creditworthiness of the partners or the value of the partnership's other assets. Similarly, the factor that no lender has committed to fund the transfer of cash to C may be offset by facts establishing that the partnership is obligated to attempt to obtain such a loan and that its ability to obtain such a loan is not significantly dependent on the value that will be added by successful completion of the building, or that the partnership reasonably anticipates that it will have (and will utilize) an alternative source to fund the transfer of cash to C if the permanent loan proceeds are inadequate.

Example 4. Operation of presumption for transfers within two years. E is a partner in the equal EF partnership. The partnership owns two parcels of unimproved real property (*parcels 1 and 2*). Parcels 1 and 2 are unencumbered. Parcel 1 has a fair market value of $500,000, and parcel 2 has a fair market value of $1,500,000. E transfers additional unencumbered, unimproved real property (*parcel 3*) with a fair market value of $1,000,000 to the partnership in exchange for an increased interest in partnership profits of 66⅔ percent. Immediately after this transfer, the partnership sells parcel 1 for $500,000 in a transaction not in the ordinary course of business. The partnership transfers the proceeds of the sale $333,333 to E and $166,667 to F in accordance with their respective partnership interests. The transfer of $333,333 to E is presumed to be, in accordance with paragraph (c) of this section, a sale, in part, of parcel 3 to the partnership. However, the facts of this example clearly establish that $250,000 of the transfer to E is not part of a sale of parcel 3 to the partnership because E would have been distributed $250,000 from the sale of parcel 1 whether or not E had transferred parcel 3 to the partnership. The transfer to E exceeds by $83,333 ($333,333 minus $250,000) the amount of the distribution that would have been made to E if E had not transferred parcel 3 to the partnership. Therefore, $83,333 of the transfer is presumed to be part of a sale of a portion of parcel 3 to the partnership by E.

Example 5. Operation of presumption for transfers more than two years apart. (i) G transfers undeveloped land to the GH partnership in exchange for an interest in the partnership. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of $500,000 and a fair market value of $1,000,000. H contributes $1,000,000 in cash in exchange for an interest in the partnership. Under the partnership agreement, the partnership is obligated to construct a building on the land. The projected construction cost is $5,000,000, which the partnership plans to fund with its $1,000,000 in cash and the proceeds of a construction loan secured by the land and improvements.

(ii) Shortly before G's transfer of the land to the partnership, the partnership secures commitments from lending institutions for construction and permanent financing. To obtain the construction loan, H guarantees completion of the building for a cost of $5,000,000. The partnership is not obligated to reimburse or indemnify H if H must make payment on the completion guarantee. The permanent loan will be funded upon completion of the building, which is expected to occur two years after G's transfer of the land. The amount of the permanent loan is to equal the lesser of $5,000,000 or 80 percent of the appraised value of the improved property at the time the permanent loan is closed. Under the partnership agreement, the partnership is obligated to apply the proceeds of the permanent loan to retire the construction loan and to hold any excess proceeds for transfer to G 25 months after G's transfer of the land to the partnership. The appraised value of the improved property at the time the permanent loan is closed is expected to exceed $5,000,000 only if the partnership is able to lease a substantial portion of the improvements by that time, and there is a significant risk that the partnership will not be able to achieve a satisfactory occupancy level. The partnership completes construction of the building for the projected cost of $5,000,000 approximately two years after G's transfer of the land. Shortly thereafter, the permanent loan is funded in the amount of $5,000,000. At the time of funding the land and building have an appraised value of $7,000,000. The partnership transfers the $1,000,000 excess permanent loan proceeds to G 25 months after G's transfer of the land to the partnership.

(iii) G's transfer of the land to the partnership and the partnership's transfer of $1,000,000 to G occurred more than two years apart. In accordance with paragraph (d) of this section, those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale of the property, in whole or part, to the partnership. The transfer of $1,000,000 to G would not have been made but for G's transfer of the land to the partnership. In addition, at the time G transferred the land to the partnership, G had a legally enforceable right to receive a transfer from the partnership at a specified time an amount that equals the excess of the permanent loan proceeds over $4,000,000. In this case, however, there was a significant risk that the appraised value of the property would be insufficient to support a permanent loan in excess of $4,000,000 because of the risk that the partnership would not be able to achieve a sufficient occupancy level. Therefore, the facts of this example indicate that at the time G transferred the land to the partnership the subsequent transfer of $1,000,000 to G depended on the entrepreneurial risks of partnership operations. Accordingly, G's transfer of the land to the partnership is not treated as part of a sale.

Example 6. Rebuttal of presumption for transfers more than two years apart. The facts are the same as in *Example 5*, except that the partnership is able to secure a commitment for a permanent loan in the amount of $5,000,000 without regard to the appraised value of the improved property at the time the permanent loan is funded. Under these facts, at the time that G transferred the land to the partnership the subsequent transfer of $1,000,000 to G was not dependent on the entrepreneurial risks of partnership operations, because during the period before the permanent loan is funded, the permanent lender's obligation to make a loan in the amount necessary to fund the transfer is not subject to the contingencies related to the risks of partnership operations, and after the permanent loan is funded, the partnership holds liquid assets sufficient to make the transfer. Therefore, the facts and circumstances clearly establish that G's transfer of the land to the partnership is part of a sale.

Example 7. Operation of presumption for transfers more than two years apart. The facts are the same as in *Example 6*, except that H does not guarantee either that the improvements will be completed or that the cost to the partnership of completing the improvements will not exceed $5,000,000. Under these facts, if there is a significant risk that the improvements will not be completed, G's transfer of the land to the partnership will not be treated as part of a sale because the lender is required to make the permanent loan if the improvements are not completed. Similarly, the transfers will not be treated as a sale to the extent that there is a significant risk that the cost of constructing the improvements will exceed $5,000,000, because, in the absence of a guarantee of the cost of the improvements by H, the $5,000,000 proceeds of the permanent loan might not be sufficient to retire the construction loan and fund the transfer to G. In either case, the transfer of cash to G would be dependent on the entrepreneurial risks of partnership operations.

Example 8. Rebuttal of presumption for transfers more than two years apart. (i) On February 1, 1992, I, J, and K form partnership IJK. On formation of the partnership, I transfers an unencumbered office building with a fair market value of $50,000,000 and an adjusted tax basis of $20,000,000 to the partnership, and J and K each transfer United States government securities with a fair market value and an adjusted tax basis of $25,000,000 to the partnership. Substantially all of the rentable space in the office building is leased on a long-term basis. The partnership agreement provides that all items of income, gain, loss, and deduction from the office building are to be allocated 45 percent to J, 45 percent to K, and 10 percent to I. The partnership agreement also provides that all items of income, gain, loss, and deduction from the government securities are to be allocated 90 percent to I, 5 percent to J, and 5 percent to K. The partnership agreement requires that cash flow from the office building and government securities be allocated between partners in the same manner as the items of income, gain, loss, and deduction from those properties are allocated between them. The partnership agreement complies with the requirements of § 1.704–1(b)(2)(ii)(*b*). It is not expected that the partnership will need to resort to the government securities or the cash flow therefrom to operate the office building. At the time the partnership is formed, I, J, and K contemplated that I's interest in the partnership would be liquidated sometime after January 31, 1994, in exchange for a transfer of the government securities and cash (if necessary). On March 1, 1995, the partnership transfers cash and the government securities to I in liquidation of I's interest in the partnership. The cash transferred to I represents the excess of I's share of the appreciation in the office building since the formation of the partnership over J's and K's share of the appreciation in the government securities since they are acquired by the partnership.

(ii) I's transfer of the office building to the partnership and the partnership's transfer of the government securities and cash to I occurred more than two years apart. Therefore, those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale. Absent I's transfer of the office building to the partnership, I would not have received the government securities from the partnership. The facts including the amount and nature of partnership assets) indicate that, at the time that I transferred the office building to the partnership, the timing of the transfer of the government securities to I was anticipated and was not dependent on the entrepreneurial risks of partnership operations. Moreover, the facts indicate that the partnership allocations were designed to effect an exchange of the burdens and benefits of ownership of the government securities in anticipation of the transfer of those securities to I and those burdens and benefits were effectively shifted to I on formation of the partnership. Accordingly, the facts and circumstances clearly establish that I sold the office building to the partnership on February 1, 1992, in exchange for the partnership's obligation to transfer the government securities to I and to make certain other cash transfers to I.

§ 1.707–4 Disguised sales of property to partnership; special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures.

(a) *Guaranteed payments and preferred returns*—(1) *Guaranteed payment not treated as part of a sale*—(i) *In general.* A guaranteed payment for capital made to a partner is not treated as part of a sale of property under § 1.707–3(a) (relating to treatment of transfers as a sale). A party's characterization of a payment as a guaranteed payment for capital will not control in determining whether a payment is, in fact, a guaranteed payment for capital. The term *guaranteed payment for capital* means 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. See section 707(c). For this purpose, one or more payments are not made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership.

(ii) *Reasonable guaranteed payments.* Notwithstanding the presumption set forth in § 1.707–3(c) (relating to transfers made within two years of each other), for purposes of section 707(a)(2) and the regulations thereunder a transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital, is determined without regard to the income of the partnership and is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iii) *Unreasonable guaranteed payments.* A transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital but that is not reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is a guaranteed payment for capital. A transfer that is not a guaranteed payment for capital is subject to the rules of § 1.707-3.

(2) *Presumption regarding reasonable preferred returns.* Notwithstanding the presumption set forth in § 1.707-3(c) (relating to transfers made within two years of each other), a transfer of money to a partner that is characterized by the parties as a preferred return and that is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be part of a sale of property to the partnership unless the facts and circumstances (including the likelihood and expected timing of the subsequent allocation of income or gain to support the preferred return) clearly establish that the transfer is part of a sale. The term *preferred return* means 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.

(3) *Definition of reasonable preferred returns and guaranteed payments*—(i) *In general.* A transfer of money to a partner that is characterized as a preferred return or guaranteed payment for capital is reasonable only to the extent that 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.

(ii) *Reasonable amount.* A transfer of money that is made to a partner during any partnership taxable year and 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 (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid preferred return or guaranteed payment for capital that is payable to the partner) by the safe harbor interest rate for that year. The safe harbor interest rate for a partnership's taxable year equals 150 percent of the highest applicable federal rate, at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year. A partner's unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than transfers of money that are presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, transfers of money that are reasonable preferred returns within the meaning of this paragraph (a)(3), and operating cash flow distributions within the meaning of paragraph (b)(2) of this section.

(4) *Examples.* The following examples illustrate the application of paragraph (a) of this section:

Example 1. Transfer presumed to be a guaranteed payment. (i) A transfers property with a fair market value of $100,000 to partnership AB. At the time of A's 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 percent (compounded annually) 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 that 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 made to A are treated as guaranteed payments under section 707(c). Under the partnership agreement, that deduction would be allocated in the same manner as any other item of partnership deduction. The partnership agreement complies with the requirements of § 1.704-1(b)(2)(ii)(*b*). The partnership agreement does not provide for the payment of a preferred return and, other than the guaranteed payment to be paid to A, no transfer is expected to be made during the three year period following A's transfer that is not an operating cash flow distribution (within the meaning of paragraph (b)(2) of this section). Assume that the highest applicable federal rate in effect at the time of A's transfer is eight percent compounded annually.

(ii) The transfer of money to be made to A under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of § 1.707-4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in § 1.707-3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital but is part of a sale.

(iii) The presumption that the transfer is a guaranteed payment for capital is not rebutted, because there are no facts indicating that the transfer is not a guaranteed payment for the use of capital.

Example 2. Transfers characterized as guaranteed payments treated as part of a sale. (i) C and D form partnership CD. C transfers property with a fair market value of $100,000 and an adjusted tax basis of $20,000 in exchange for a partnership interest. D is responsible for managing the day-to-day operations of the partnership and makes no capital contribution to the partnership upon its formation. The partnership agreement provides that C is to receive payments characterized as guaranteed payments and determined without regard to partnership income of $8,333 per year for the first four years of partnership operations for the use of C's capital. In addition, the partnership agreement provides that—

(A) Partnership net taxable income and loss will be allocated 75 percent to C and 25 percent to D; and

(B) All partnership cash flow (determined prior to consideration of the guaranteed payment) will be distributed 75 percent to C and 25 percent to D except that guaranteed payments that the partnership is obligated to make to C are payable solely out of D's share of the partnership's cash flow.

(ii) If D's share of the partnership's cash flow is not sufficient to make the guaranteed payment to C, then D is obligated to contribute any shortfall to the partnership, even in the event the partnership is liquidated. Thus, the effect of the guaranteed payment arrangement is that the guaranteed payment to C is funded entirely by D. The partnership agreement complies with the requirements of § 1.704-1(b)(2)(ii)(*b*). Assume that, at the time the partnership is formed, the partnership or D could borrow $25,000 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 percent (compounded annually). Assume that the highest applicable federal rate in effect at the time the partnership is formed is 10 percent compounded annually.

(iii) The transfer of money to be made to C under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of § 1.707-4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in § 1.707-3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iv) For the first four years of partnership operations, the total guaranteed payments made to C under the partnership agreement will equal $33,332. If the characterization of those payments as guaranteed payments for capital within the meaning of section 707(c) were respected, C would be allocated $24,999 of the deductions that would be claimed by the partnership for those payments, thereby leaving the balance in C's capital account approximately $25,000 less than it would have been if the guaranteed payments had not been made. The guaranteed payments thus 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 resulting capital account is approximately equivalent to the capital account C would have had if C had only contributed 75 percent of the property to the partnership. Furthermore, the effect of D's funding the guaranteed payment to C (either through reduced distributions of cash flow to D or additional contributions) is that D's capital account is approximately equivalent to the capital account D would have had if D had contributed 25 percent of the property (or contributed cash so that the partnership could purchase the 25 percent). Moreover, a $25,000 loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of 12 percent (compounded annually), would have resulted in annual payments of principal and interest of $8,230.86. Consequently, the guaranteed payments effectively place the partners in the same economic position that they would have been in had D purchased a one-quarter interest in the property from C financed at the current market rate of interest, and then C and D each contributed their share of the property to the partnership. In view of the burden the guaranteed payments place on D's right to transfers of partnership cash flow and D's legal obligation to make contributions to the partnership to the extent necessary to fund the guaranteed payments, D has effectively purchased through the partnership a one-quarter interest in the property from C.

(v) 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 § 1.707-3(a), C and the partnership are treated as if C 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 payments.

(b) *Presumption regarding operating cash flow distributions*—(1) *In general.* Notwithstanding the presumption set forth in § 1.707-3(c) (relating to transfers made within two years of each other), an operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale.

(2) *Operating cash flow distributions*—(i) *In general.* One or more transfers of money by the partnership to a partner during a taxable year of the partnership are operating cash flow distributions for purposes of paragraph (b)(1) of this section to the extent that those transfers are not presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, are not reasonable preferred returns within the meaning of paragraph (a)(3) of this section, are not characterized by the parties as distributions to the partner acting in a capacity other than as a partner, and to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner's percentage interest in overall partnership profits for that year or the partner's percentage interest in overall partnership profits for the life of the partnership. For purposes of the preceding sentence, the net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership's business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by—

(A) Principal payments made on any partnership indebtedness;

(B) Property replacement or contingency reserves actually established by the partnership;

(C) Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow; and

(D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

(ii) *Operating cash flow safe harbor.* For any taxable year, in determining a partner's operating cash flow distributions for the year, the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year. This provision is merely intended to provide taxpayers with a safe harbor and is not intended to preclude a taxpayer from using a different percentage under the rules of paragraph (b)(2)(i) of this section.

(iii) *Tiered partnerships.* In the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership applying principles similar to those described in paragraph (b)(2)(i) of this section, so that the amount of the upper-tier partnership's operating cash flow distributions is neither overstated nor understated.

(c) *Accumulation of guaranteed payments, preferred returns, and operating cash flow distributions.* Guaranteed payments for capital, preferred returns, and operating cash flow distributions presumed not to be part of a sale under the rules of paragraphs (a) and (b) of this section do not lose the benefit of the presumption by reason of being retained for distribution in a later year.

(d) *Exception for reimbursements of preformation expenditures.* A transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under § 1.707-3(a) (relating to treatment of transfers as a sale) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that—

(1) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and

(2) Are incurred by the partner with respect to—

(i) Partnership organization and syndication costs described in section 709; or

(ii) Property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the contribution. However, the 20 percent of fair market value limitation of this paragraph (d)(2)(ii) does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution.

(e) *Other exceptions.* The Commissioner may provide by guidance published in the Internal Revenue Bulletin that other payments or transfers to a partner are not treated as part of a sale for purposes of section 707(a)(2) and the regulations thereunder.

§ 1.707-5 Disguised sales of property to partnership; special rules relating to liabilities.

(a) *Liability assumed or taken subject to by partnership*—(1) *In general.* For purposes of this section and §§ 1.707-3 and 1.707-4, if a partnership assumes or takes property subject to a qualified liability (as defined in paragraph (a)(6) of this section) of a partner, the partnership is treated as transferring consideration to the partner only to the extent provided in paragraph (a)(5) of this section. By contrast, if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability as provided in paragraphs (a) (2), (3) and (4) of this section.

(2) *Partner's share of liability.* A partner's share of any liability of the partnership is determined under the following rules:

(i) *Recourse liability.* A partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of section 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under § 1.752-1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section.

(ii) *Nonrecourse liability.* A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under § 1.752-1(a)(2) or would be a nonrecourse liability of the partnership under § 1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section.

(3) *Reduction of partner's share of liability.* For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if—

(i) At the time that the partnership assumes or takes subject to a liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced; and

(ii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a sale under § 1.707-3.

(4) *Special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan.* For purposes of paragraph (a)(1) of this section, if the partnership assumes or takes property or properties subject to the liabilities of more than one partner pursuant to a plan, a partner's share of the liabilities assumed or taken subject to by the partnership pursuant to that plan immediately after the transfers equals the sum of that partner's shares of the liabilities (other than that partner's qualified liabilities, as defined in paragraph (a)(6) of this section) assumed or taken subject to by the partnership pursuant to the plan. This paragraph (a)(4) does not apply to any liability assumed or taken subject to by the partnership with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by the partnership is treated as a transfer of consideration under paragraph (a)(1) of this section.

(5) *Special rule applicable to qualified liabilities.* (i) If a transfer of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership's assumption of or taking subject to a qualified liability in connection with a transfer of property is not treated as part of a sale. If a transfer of property by a partner to the partnership is treated as part of a sale without regard to the partnership's assumption of or taking subject to a qualified liability (as defined in paragraph (a)(6) of this section) in connection with the transfer of property, the partnership's assumption of or taking subject to that liability is treated as a transfer of consideration made pursuant to a sale of such property to the partnership only to the extent of the lesser of—

(A) The amount of consideration that the partnership would be treated as transferring to the partner under paragraph (a)(1) of this section if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the amount of the qualified liability by the partner's net equity percentage with respect to that property.

(ii) A partner's net equity percentage with respect to an item of property equals the percentage determined by dividing—

(A) The aggregate transfers of money or other consideration to the partner by the partnership (other than any transfer described in this paragraph (a)(5)) that are treated as proceeds realized from the sale of the transferred property; by

(B) 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 or, in the case of any qualified liability described in paragraph (a)(6)(i)(C) or (D) of this section, that is properly allocable to the property.

(6) *Qualified liability of a partner defined.* A liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is qualified liability of the partner only to the extend—

(i) The liability is—

(A) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfers the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;

(B) A liability that was not incurred in anticipation of the transfer of the property to a partnership, buy that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a property transfer or of a written agreement to transfer);

(C) A liability that is allocable under the rules of § 1.163-8T to capital expenditures with respect to the property; or

(D) A 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 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; and

(ii) If the liability is a recourse liability, the amount of the liability does not exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraph (a)(6)(i) (C) or (D) of this section) at the time of the transfer.

(7) *Liability incurred within two years of transfer presumed to be in anticipation of the transfer*—(i) *In general.* For purposes of this section, if within a two-year period a partner incurs a liability (other than a liability described in paragraph (a)(6)(i) (C) or (D) of this section) and transfers property to a partnership or agrees in

writing to transfer the property, and in connection with the transfer the partnership assumes or takes the property subject to the liability, the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer.

(ii) *Disclosure of transfers of property subject to liabilities incurred within two years of the transfer.* If a partner treats a liability assumed or taken subject to by a partnership as a qualified liability under paragraph (a)(6)(i)(B) of this section, such treatment is to be disclosed to the Internal Revenue Service in accordance with § 1.707–8.

(b) *Treatment of debt-financed transfers of consideration by partnerships*—(1) *In general.* For purposes of § 1.707–3, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under § 1.163–8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.

(2) *Partner's allocable share of liability*—(i) *In general.* A partner's allocable share of a partnership liability for purposes of paragraph (b)(1) of this section equals the amount obtained by multiplying the partner's share of the liability as described in paragraph (a)(2) of this section by the fraction determined by dividing—

(A) The portion of the liability that is allocable under § 1.163–8T to the money or other property transferred to the partner; by

(B) The total amount of the liability.

(ii) *Debt-financed transfers made pursuant to a plan.*—(A) *In general.* Except as provided in paragraph (b)(2)(iii) of this section, if a partnership transfers to more than one partner pursuant to a plan all or a portion of the proceeds of one or more partnership liabilities, paragraph (b)(1) of this section is applied by treating all of the liabilities incurred pursuant to the plan as one liability, and each partner's allocable share of those liabilities equals the amount obtained by multiplying the sum of the partner's shares of each of the respective liabilities (as defined in paragraph (a)(2) of this section) by the fraction obtained by dividing—

(*1*) The portion of those liabilities that is allocable under § 1.163–8T to the money or other consideration transferred to the partners pursuant to the plan; by

(*2*) The total amount of those liabilities.

(B) *Special rule.* Paragraph (b)(2)(ii)(A) of this section does not apply to any transfer of money or other property to a partner that is made with a principal purpose of reducing the extent to which any transfer is taken into account under paragraph (b)(1) of this section.

(iii) *Reduction of partner's share of liability.* For purposes of paragraph (b)(2) of this section, a partner's share of a liability, immediately after the partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if—

(A) It is anticipated that the partner's share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer; and

(B) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership's distribution of the proceeds of the borrowing is treated as part of a sale.

(c) *Refinancings.* To the extent that the proceeds of a partner or partnership liability (the *refinancing debt*) are allocable under the rules of § 1.163–8T to payments discharging all or part of any other liability of that partner or of the partnership, as the case may be, the refinancing debt is treated as the other liability for purposes of applying the rules of this section.

(d) *Share of liability where assumption accompanied by transfer of money.* For purposes of §§ 1.707–3 through 1.707–5, if pursuant to a plan a partner pays or contributes money to the partnership and the partnership assumes or takes subject to one or more liabilities (other than qualified liabilities) of the partner, the amount of those liabilities that the partnership is treated as assuming or taking subject to is reduced (but not below zero) by the money transferred.

(e) *Tiered partnerships and other related persons.* If a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the characterization as qualified or nonqualified that it had under these rules in the upper-tier partnership. A similar rule applies to other related party transactions involving liabilities to the extent provided by guidance published in the Internal Revenue Bulletin.

(f) *Examples.* The following examples illustrate the application of this section.

Example 1. Partnership's assumption of nonrecourse liability encumbering transferred property. (i) A and B form partnership AB, which will engage in renting office space. A transfers $500,000 in cash to the partnership, and B transfers an office building to the partnership. At the time it is transferred to the partnership, the office building has a fair market value of $1,000,000, an adjusted basis of $400,000, and is encumbered by a $500,000 liability, which B incurred 12 months earlier to finance the acquisition of other property. No facts rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Assume that this liability is a nonrecourse liability of the partnership within the meaning of section 752 and the regulations thereunder. The partnership agreement provides that partnership items will be allocated equally between A and B, including excess nonrecourse deductions under § 1.752–3(a)(3). The partnership agreement complies with the requirements of § 1.704–1(b)(2)(ii)(*b*).

(ii) The nonrecourse liability secured by the office building is not a qualified liability within the meaning of paragraph (a)(6) of this section. B would be allocated 50 percent of the excess nonrecourse liability under the partnership agreement. Accordingly, immediately after the partnership's assumption of that liability, B's share of the liability equals $250,000, which is equal to B's 50 percent share of the excess nonrecourse liability of the partnership as determined in accordance with B's share of partnership profits under § 1.752–3(a)(3).

(iii) The partnership's taking subject to the liability encumbering the office building is treated as a transfer of $250,000 of consideration to B (the amount by which the liability ($500,000) exceeds B's share of that liability immediately after taking subject to $250,000)). B is treated as having sold $250,000 of the fair market value of the office building to the partnership in exchange for the partnership's taking subject to a $250,000 liability. This results in a gain of $150,000 ($250,000 minus ($250,000/$1,000,000 multiplied by $400,000)).

Example 2. Partnership's assumption of recourse liability encumbering transferred property. (i) C transfers property Y to a partnership. At the time of its transfer to the partnership, property Y has a fair market value of $10,000,000 and is subject to an $8,000,000 liability that C incurred, immediately before transferring property Y to the partnership, in order to finance other expenditures. Upon the transfer of property Y to the partnership, the partnership assumed the liability encumbering that property. The partnership assumed this liability solely to acquire property Y. Under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership and C's share of that liability is $7,000,000.

(ii) Under the facts of this example, the liability encumbering property Y is not a qualified liability.

Accordingly, the partnership's assumption of the liability results in a transfer of consideration to C in connection with C's transfer of property Y to the partnership in the amount of $1,000,000 (the excess of the liability assumed by the partnership ($8,000,000) over C's share of the liability immediately after the assumption ($7,000,000)). See paragraphs (a) (1) and (2) of this section.

Example 3. Subsequent reduction of transferring partner's share of liability. (i) The facts are the same as in Example 2. In addition, property Y is a fully leased office building, the rental income from property Y is sufficient to meet debt service, and the remaining term of the liability is ten years. It is anticipated that, three years after the partnership's assumption of the liability, C's share of the liability under section 752 will be reduced to zero because of a shift in the allocation of partnership losses pursuant to the terms of the partnership agreement. Under the partnership agreement, this shift in the allocation of partnership losses is dependent solely on the passage of time.

(ii) Under paragraph (a)(3) of this section, if the reduction in C's share of the liability was anticipated at the time of C's transfer, and the reduction was part of a plan that has as one of its principal purposes minimizing the extent of sale treatment under § 1.707–3 (*i.e.*, a principal purpose of allocating a large percentage of losses to C in the first three years when losses were not likely to be realized was to minimize the extent to which C's transfer would be treated as part of a sale), C's share of the liability immediately after the assumption is treated as equal to C's reduced share.

Example 4. Trade payables as qualified liabilities. (i) D and E form partnership DE which will engage in a consulting business that requires no overhead and minimal cash on hand for daily operating expenses. Previously, D and E, as individual sole proprietors, operated separate consulting businesses. D and E each transfer to the partnership sufficient cash to cover daily operating expenses together with the goodwill and trade payables related to each sole proprietorship. Due to uncertainty over the collection rate on the trade receivables related to their sole proprietorships, D and E agree that none of the trade receivables will be transferred to the partnership.

(ii) Under the facts of this example, all the assets related to the consulting business (other than the trade receivables) together with the trade payables were transferred to partnership DE. The trade receivables retained by D and E are not material to a continuation of the trade or business by the partnership because D and E contributed sufficient cash to cover daily operating expenses. Accordingly, the trade payables transferred to the partnership constitute qualified liability under paragraph (a)(6) of this section.

Example 5. Partnership's assumption of a qualified liability as sole consideration. (i) F transfers property Z to a partnership. At the time of its transfer to the partnership, property Z has a fair market value of $165,000 and an adjusted tax basis of $75,000. Also, at the time of the transfer, property Z is subject to a $75,000 liability that F incurred more than two years before transferring property Z to the partnership. The liability has been secured by property Z since it was incurred by F. Upon the transfer of property Z to the partnership, the partnership assumed the liability encumbering that property. The partnership made no other transfers to F in consideration for the transfer of property Z to the partnership. Assume that, under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Z, the liability is a recourse liability of the partnership and F's share of that liability is $25,000.

(ii) The $75,000 liability secured by property Z is a qualified liability of F because F incurred the liability more than two years prior to the assumption of the liability by the partnership and the liability has encumbered property Z for more than two years prior to that assumption. *See* paragraph (a)(6) of this section. Therefore, since no other transfer to F was made as consideration for the transfer of property Z, under paragraph (a)(5) of this section, the partnership's assumption of the qualified liability of F encumbering property Z is not treated as part of a sale.

Example 6. Partnership's assumption of a qualified liability in addition to other consideration. (i) The facts are the same as in *Example 5*, except that the partnership makes a transfer to D of $30,000 in money that is consideration for F's transfer of property Z to the partnership under § 1.707–3.

(ii) As in *Example 5*, the $75,000 liability secured by property Z is a qualified liability of F. Since the partnership transferred $30,000 to F in addition to assuming the qualified liability under paragraph (a)(5) of this section, the partnership's assumption of this qualified liability is treated as a transfer of additional consideration to F to the extent of the lesser of—

(A) The amount that the partnership would be treated as transferring to F if the liability were not a qualified liability ($50,000 (*i.e.*, the excess of the $75,000 qualified liability over F's $25,000 share of that liability)); or

(B) The amount obtained by multiplying the qualified liability ($75,000) by F's net equity percentage with respect to property Z (one-third).

(iii) F's net equity percentage with respect to property Z equals the fraction determined by dividing—

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to F and treated as part of a sale of property Z under § 1.707–3(a) ($30,000 transfer of money); by

(B) F's net equity in property Z ($90,000 (*i.e.*, the excess of the $165,000 fair market value over the $75,000 qualified liability)).

(iv) Accordingly, the partnership's assumption of the qualified liability of F encumbering property Z is treated as a transfer of $25,000 (one-third of $75,000) of consideration to F pursuant to a sale. Therefore, F is treated as having sold $55,000 of the fair market value of property Z to the partnership in exchange for $30,000 in money and the partnership's assumption of $25,000 of the qualified liability. Accordingly, F must recognize $30,000 of gain on the sale (the excess of the $55,000 amount realized over $25,000 of F's adjusted basis for property Z (*i.e.*, one-third of F's adjusted basis for the property, because F is treated as having sold one-third of the property to the partnership)).

Example 7. Partnership's assumptions of liabilities encumbering properties transferred pursuant to a plan. (i) Pursuant to a plan, G and H transfer property 1 and property 2, respectively, to an existing partnership in exchange for interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of $10,000 and an adjusted tax basis of $6,000, and property 2 has a fair market value of $10,000 and an adjusted tax basis of $4,000. At the time properties 1 and 2 are transferred to the partnership, a $6,000 nonrecourse liability (*liability 1*) is secured by property 1 and a $7,000 recourse liability of F (*liability 2*) is secured by property 2. Properties 1 and 2 are transferred to the partnership, and the partnership takes subject to liability 1 and assumes liability 2. G and H incurred liabilities 1 and 2 immediately prior to transferring properties 1 and 2 to the partnership and used the proceeds for personal expenditures. The liabilities are not qualified liabilities. Assume that G and H are each allocated $2,000 of liability 1 in accordance with § 1.707–5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability). Assume further that G's share of liability 2 is $3,500 and H's share is $0 in accordance with § 1.707–5(a)(2)(i) (which determines a partner's share of a recourse liability).

(ii) G and H transferred properties 1 and 2 to the partnership pursuant to a plan. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of only $500 of consideration to G, (the amount by which liability 1 ($6,000) exceeds G's share of liabilities 1 and 2 ($5,500)), and the partnership's assumption of liability 2 is treated as a transfer of only $5,000 of consideration to H (the amount by which liability 2 ($7,000) exceeds H's share of liabilities 1 and 2 ($2,000)). G is treated under the rule in § 1.707–3 as having sold $500 of the fair market value of property 1 in exchange for the partnership's taking subject to liability 1 and H is treated as having sold $5,000 of the fair market value of property 2 in exchange for the assumption of liability 2.

Example 8. Partnership's assumption of liability pursuant to a plan to avoid sole treatment of partnership assumption of another liability. (i) The facts are the same as in *Example 7*, except that—

(A) H transferred the proceeds of liability 2 to the partnership; and

(B) H incurred liability 2 in an attempt to reduce the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G (and thereby reduce the portion of G's transfer of property 1 to the partnership that would be treated as part of a sale).

(ii) Because the partnership assumed liability 2 with a principal purpose of reducing the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G. liability 2 is ignored in applying paragraph (a)(3) of this section. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of $4,000 of consideration to G (the amount by which liability 1 ($6,000) exceeds G's share of liability 1 ($2,000)). On the other hand, the partnership's assumption of liability 2 is not treated as a transfer of any consideration to H because H's share of that liability equals $7,000 as a result of H's transfer of $7,000 in money to the partnership.

Example 9. Partnership's assumptions of qualified liabilities encumbering properties transferred pursuant to a plan in addition to other consideration. (i) Pursuant to a plan, I transfers property 1 and J transfers property 2 plus $10,000 in cash to partnership IJ in exchange for equal interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of $100,000, an adjusted tax basis of $5,000, and is encumbered by a qualified liability of $50,000 (*liability 1*). Property 2 has a fair market value of $100,000, an adjusted tax basis of $5,000, and is encumbered by a qualified liability of $70,000 (*liability 2*). Pursuant to the plan, the partnership transferred to I $10,000 in cash. That amount is consideration for I's transfer of property 1 to the partnership under § 1.707-3. In accordance with § 1.707-5(a)(2), I and J are each allocated $25,000 of liability 1 and $35,000 of liability 2.

(ii) Because the partnership transferred $10,000 to I as consideration for the transfer of property, under § 1.707-5(a)(5), the partnership's assumption of liability 1 is treated as a transfer of additional consideration to I, even though liability 1 is a qualified liability, to the extent of the lesser of—

(A) The amount that the partnership would be treated as transferring to I if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the qualified liability by I's net equity percentage with respect to property 1.

(iii) Because I and J transferred properties 1 and 2 to the partnership pursuant to a plan, treating I's qualified liability as a nonqualified liability under § 1.707-5(a)(5)(i)(A) enables I to apply the special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan under § 1.707-5(a)(4). Under this alternative test, the partnership's assumption of liability 1 encumbering property 1 is treated as a transfer of zero ($0) additional consideration to I pursuant to a sale. This is because the amount of liability 1 ($50,000) does not exceed the sum of I's share of liability 1 treated as a nonqualified liability ($25,000) and I's share of liability 2 ($35,000)).

(iv) The alternative under § 1.707-5(a)(5)(i)(B) is the amount obtained by multiplying the qualified liability ($50,000) by I's net equity percentage with respect to property 1. I's net equity percentage with respect to property 1 equals one-fifth, the fraction determined by dividing—

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to I and treated as part of a sale of property 1 under § 1.707-3(a) (the $10,000 transfer of money); by

(B) I's net equity in property 1 ($50,000 *i.e.*, the excess of the $100,000 fair market value over the $50,000 qualified liability).

(v) Under this alternative test, the partnership's assumption of the qualified liability encumbering property 1 is treated as a transfer of $10,000 (one-fifth of the $50,000 qualified liability) of additional consideration to I pursuant to a sale.

(vi) Applying § 1.707-5(a)(5) to these facts, the partnership's assumption of liability 1 is treated as a transfer of additional consideration to I to the extent of the lesser of—

(A) zero; or

(B) $10,000.

(vii) Therefore, the partnership's assumption of I's qualified liability encumbering property 1 is not treated as a transfer of any additional consideration to I pursuant to a sale, and I is treated as having only received $10,000 of the fair market value of property 1 to the partnership in exchange for $10,000 in cash. Accordingly, I must recognize $9,500 of gain on the sale, that is, the excess of the $10,000 amount realized over $500 of I's adjusted tax basis for property 1 (one-tenth of I's adjusted tax basis for the property, because I is treated as having sold one-tenth of the property to the partnership). Since no other transfer to J was made as consideration for the transfer of property 2, the partnership's assumption of the qualified liability of J encumbering property 2 is not treated as part of a sale.

Example 10. Treatment of debt-financed transfers of consideration by partnership. (i) K transfers property Z to partnership KL in exchange for an interest therein on April 9, 1992. On September 13, 1992, the partnership incurs a liability of $20,000. On November 17, 1992, the partnership transfers $20,000 to K, and $10,000 of this transfer is allocable under the rules of § 1.163-8T to proceeds of the partnership liability incurred on September 13, 1992. The remaining $10,000 is paid from other partnership funds. Assume that, under section 752 and the corresponding regulations, the $20,000 liability incurred on September 13, 1992, is a recourse liability of the partnership and K's share of that liability is $10,000 on November 17, 1992.

(ii) Because a portion of the transfer made to K on November 17, 1992, is allocable under § 1.163-8T to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the rules of this section and § 1.707-3 only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the $20,000 liability used to fund $10,000 of the transfer to K is $5,000 (K's share of the liability ($10,000) multiplied by the fraction obtained by dividing—

(A) The amount of the liability that is allocable to the distribution to K ($10,000); by

(B) The total amount of such liability ($20,000)).

(iii) Therefore, K is required to take into account only $15,000 of the $20,000 partnership transfer to K for purposes of this section and § 1.707-3. Under these facts, assuming the within-two-year presumption is not rebutted, this $15,000 transfer will be treated under the rule in § 1.707-3 as part of a sale by K of property Z to the partnership.

Example 11. Borrowing against pool of receivables. (i) M generates receivables which have an adjusted basis of zero in the ordinary course of its business. For M to use receivables as security for a loan, a commercial lender requires M to transfer the receivables to a partnership in which M has a 90 percent interest. In January, 1992, M transfers to the partnership receivables with a face value of $100,000. N (who is not related to M) transfers $10,000 cash to the partnership in exchange for a 10 percent interest. The partnership borrows $80,000, secured by the receivables, and makes a distribution of $72,000 of the proceeds to M and $8,000 of the proceeds to N within 90 days of incurring the liability. M's share of the liability under § 1.707-5(a)(2) is $72,000 (90 percent × $80,000).

(ii) Because the transfer of the loan proceeds to M is allocable under § 1.163-8T to proceeds of a partnership loan that was incurred by the partnership within 90 days of that transfer, M is required to take the transfer into account in applying the rules of this section and § 1.707-3 only to the extent that the amount of the transfer ($72,000) exceeds M's allocable share of the liability used to fund the transfer. Because the distribution was a debt-financed transfer pursuant to a plan, M's allocable share of the liability is $72,000 ($72,000 × $80,000/80,000) under § 1.707-5(b)(2)(ii). Therefore, M is not required to take into account any of the loan proceeds for purposes of this section and § 1.707-3.

(iii) When the receivables are collected, M must be allocated the gain on the contributed receivables under section 704(c). However, the lender permits the partnership to distribute cash to the partners only to the extent of the value of new receivables contributed to the partnership. In 1993, M contributes additional receivables and receives a distribution of cash. The taxable income recognized by the partnership on the receivables is taxable income of the partnership arising in the ordinary course of the partnership's activities. To the extent the distribution does not exceed 90 percent (M's percentage interest in overall partnership profits) of the partnership's operating cash flow under § 1.707-4(b), the distribution to M is presumed not to be a part of a sale of receivables by M to the partnership, and the presumption is not rebutted under these facts.

§ 1.707-6 Disguised sales of property by partnership to partner; general rules.

(a) *In general.* Rules similar to those provided in § 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.

(b) *Special rules relating to liabilities*—(1) *In general.* Rules similar to those provided in § 1.707-5 apply to determine the extent to which an assumption of or taking subject to a liability by a partner, in connection with a transfer of property by a partnership, is considered part of a sale. Accordingly, if a partner assumes or takes property subject to a qualified liability (as defined in paragraph (b)(2) of this section) of a partnership, the partner is treated as transferring consideration to the partnership only to the extent provided in paragraph (b). If the partner assumes or takes subject to a liability that is not a qualified liability, the amount treated as consideration transferred to the partnership is the amount that the liability assumed or taken subject to by the partner exceeds the partner's share of that liability (determined under the rules of § 1.707-5(a)(2)) immediately before the transfer. Similar to the rules provided in § 1.707-5(a)(4), if more than one partner assumes or takes subject to a liability pursuant to a plan, the amount that is treated as a transfer of consideration by each partner is the amount by which all of the liabilities (other than qualified liabilities) assumed or taken subject to by the partner pursuant to the plan exceed the partner's share of all of those liabilities immediately before the assumption or taking subject to. This paragraph (b)(1) does not apply to any liability assumed or taken subject to by a partner with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by a partner is treated as a transfer of consideration under this paragraph (b).

(2) *Qualified liabilities.* (i) If a transfer of property by a partnership to a partner is not otherwise treated as part of a sale, the partner's assumption of or taking subject to a qualified liability is not treated as part of a sale. If a transfer of property by a partnership to the partner is treated as part of a sale without regard to the partner's assumption of or taking subject to a qualified liability, the partner's assumption of or taking subject to that liability is treated as a transfer of consideration made pursuant to a sale of such property to the partner only to the extent of the lesser of—

(A) The amount of consideration that the partner would be treated as transferring to the partnership under paragraph (b) of this section if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the amount of the liability at the time of its assumption or taking subject to by the partnership's net equity percentage with respect to that property.

(ii) A partnership's net equity percentage with respect to an item of property encumbered by a qualified liability equals the percentage determined by dividing—

(A) The aggregate transfers to the partnership from the partner (other than any transfer described in this paragraph (b)(2)) that are treated as the proceeds realized from the sale of the transferred property to the partner, by

(B) The excess of the fair market value of the property at the time it is transferred to the partner over any qualified liabilities of the partnership that are assumed or taken subject to by the partner at that time.

(iii) For purposes of this section, the definition of a qualified liability is that provided in § 1.707-5(a)(6) with the following exceptions—

(A) In applying the definition, the qualified liability is one that is originally an obligation of the partnership and is assumed or taken subject to by the partner in connection with a transfer of property to the partner; and

(B) If the liability was incurred by the partnership more than two years prior to the earlier of the date the partnership agrees in writing to transfer the property or the date the partnership transfers the property to the partner, that liability is a qualified liability whether or not it has encumbered the transferred property throughout the two-year period.

(c) *Disclosure rules.* Similar to the rules provided in §§ 1.707-3(c)(2) and 1.707-5(a)(7)(ii), a partnership is to disclose to the Internal Revenue Service, in accordance with § 1.707-8, the facts in the following circumstances:

(1) When a partnership transfers property to a partner and the partner transfers money or other consideration to the partnership within a two-year period (without regard to the order of the transfers) and the partnership treats the transfers as other than a sale for tax purposes; and

(2) When a partner assumes or takes subject to a liability of a partnership in connection with a transfer of property by the partnership to the partner, and the partnership incurred the liability within the two-year period prior to the earlier of the date the partnership agrees in writing to the transfer of property or the date the partnership transfers the property, and the partnership treats the liability as a qualified liability under rules similar to § 1.707-5(a)(6)(i)(B).

(d) *Examples.* The following examples illustrate the rules of this section.

Example 1. Sale of property by partnership to partner. (i) A is a member of a partnership. The partnership transfers property X to A. At the time of the transfer, property X has a fair market value of $1,000,000. One year after the transfer, A transfers $1,100,000 to the partnership. Assume that under the rules of section 1274 the imputed principal amount of an obligation to transfer $1,100,000 one year after the transfer of property X is $1,000,000 on the date of the transfer.

(ii) Since the transfer of $1,100,000 to the partnership by A is made within two years of the transfer of property X to A, under rules similar to those provided in § 1.707-3(c), the transfers are presumed to be a sale unless the facts and circumstances clearly establish otherwise. If no facts exist that would rebut this presumption, on the date that the partnership transfers property X to A, the partnership is treated as having sold property X to A in exchange for A's obligation to transfer $1,100,000 to the partnership one year later.

Example 2. Assumption of liability by partner. (i) B is a member of an existing partnership. The partnership transfers property Y to B. On the date of the transfer, property Y has a fair market value of $1,000,000 and is encumbered by a nonrecourse liability of $600,000. B takes the property subject to the liability. The partnership incurred the nonrecourse liability six months prior to the transfer of property Y to B and used the proceeds to purchase an unrelated asset. Assume that, under rule of § 1.707-5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability), B's share of the nonrecourse liability immediately before the transfer of property Y was $100,000.

(ii) The liability is not allocable under the rules of § 1.163-8T to capital expenditures with respect to the property transferred to B and was not incurred in the ordinary course of the trade or business in which the property transferred to the partner was used or held. Since the partnership incurred the nonrecourse liability within two years of the transfer to B, under rules similar to those provided in § 1.707-5(a)(5), the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary. Assuming no facts exist to rebut this presumption, the liability taken subject to by B is not a qualified liability. The partnership is treated as having received, on the date of the transfer of property Y to B, $500,000 ($600,000 liability assumed by B less B's share of the $100,000 liability immediately prior to the transfer) as consideration for the sale of one-half ($500,000/$1,000,000) of property Y to B. The partnership is also treated as having distributed to B, in B's capacity as a partner, the other one-half of property Y.

§ 1.707-7 Disguised sales of partnership interests. [Reserved]

§ 1.707-8 Disclosure of certain information.

(a) *In general.* The disclosure referred to in § 1.707-3(c)(2) (regarding certain transfers made within two years of each other), § 1.707-5(a)(7)(ii) (regarding a liability incurred within two years prior to a transfer of property), and § 1.707-6(c) (relating to transfers of property from a partnership to a partner in situations analogous to those listed above) is to be made in accordance with paragraph (b) of this section.

(b) *Method of providing disclosure.* Disclosure is to be made on a completed Form 8275 or on a statement attached to the return of the transferor of property for the taxable year of the transfer that includes the following:

(1) A caption identifying the statement as disclosure under section 707;

(2) An identification of the item (or group of items) with respect to which disclosure is made;

(3) The amount of each item; and

(4) The facts affecting the potential tax treatment of the item (or items) under section 707.

(c) *Disclosure by certain partnerships.* If more than one partner transfers property to a partnership pursuant to a plan, the disclosure required by this section may be made by the partnership on behalf of all the transferors rather than by each transferor separately.

§ 1.707–9 Effective dates and transitional rules.

(a) *Sections 1.707–3 through 1.707–6*—(1) *In general.* Except as provided in paragraph (a)(3) of this section, §§ 1.707–3 through 1.707–6 apply to any transaction with respect to which all transfers that are part of a sale of an item of property occur after April 24, 1991.

(2) *Transfers occurring on or before April 24, 1991.* Except as otherwise provided in paragraph (a)(3) of this section, in the case of any transaction with respect to which one or more of the transfers occurs on or before April 24, 1991, the determination of whether the transaction is a disguised sale of property (including a partnership interest) under section 707(a)(2) is to be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 73 of the Tax Reform Act of 1984 (Pub. L. 98–369, 98 Stat. 494). See H.R. Rep. No. 861, 98th Cong., 2d Sess. 859–62 (1984); S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess. 223–32 (1984); H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1216–21 (1984).

(3) *Effective date of section 73 of the Tax Reform Act of 1984.* Sections 1.707–3 through 1.707–6 do not apply to any transfer of money or other consideration to which section 73(a) of the Tax Reform Act of 1984 (Pub. L. 98–369, 98 Stat. 494) does not apply pursuant to section 73(b) of that Act.

(b) *Section 1.707–8 disclosure of certain information.* The disclosure provisions described in § 1.707–8 apply to transactions with respect to which all transfers that are part of a sale of property occur after September 30, 1992.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. Section 602.101(c) is amended by adding the following entries in the table:

§ 602.101 OMB Control Numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control number
* * * * *	
1.707–3(c)(2)	1545–1243
1.707–5(a)(7)(ii)	1545–1243
1.707–6(c)	1545–1243
1.707–8	1545–1243
* * * * *	

Shirley D. Peterson,

Commissioner of Internal Revenue.

Approved: August 4, 1992.

Fred T. Goldberg, Jr.,

Assistant Secretary of the Treasury.

[FR Doc. 92–23726 Filed 9–25–92; 4:46 pm]

BILLING CODE 4830–01–M