REG-149519-03
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[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-149519-03]

RIN 1545-BC63

Section 707 Regarding Disguised Sales, Generally

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the treatment of transactions between a partnership and its partners as disguised sales of partnership interests between the partners under section 707(a)(2) of the Internal Revenue Code (Code). The proposed regulations affect partnerships and their partners, and are necessary to provide guidance needed to comply with the applicable tax law. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Requests to speak and outlines of topics to be discussed at the public hearing

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-149519-03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-149519-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically, via the IRS internet site http://www.irs.gov/regs or via the Federal eRulemaking Portal site at http://www.regulations.gov (indicate IRS and REG-149519-03). The public hearing will be held in the IRS Auditorium, Seventh Floor, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, James M. Gergurich or Deane M. Burke, (202) 622-3070; concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, LaNita VanDyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice or proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk

DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER].

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the **Internal Revenue Service**, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in the proposed regulations is in § 1.707-8. This information is required by the IRS to ensure that section 707(a)(2)(B) of the Code and the regulations thereunder are properly applied to transfers between partners in a partnership. The information collected will be used to determine whether partners are complying with section 707(a)(2)(B) and the regulations thereunder. The respondents will be partners and partnerships.

Estimated number of respondents: **[7,500]**.

Estimated annual frequency of responses: annually.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document proposes to amend section 707 of the Income Tax Regulations (26 CFR part 1) regarding disguised sales of partnership property, including partnership interests.

Section 707(a)(2) of the Code grants the Secretary broad regulatory authority to identify transactions that, though structured as contributions and distributions under sections 721 and 731, are more properly treated under section 707(a)(1) as transactions between the partnership and one who is not a partner or between two or more partners acting other than in their capacity as partners. The legislative history of section 707(a)(2) indicates the provision was adopted as a result of Congressional concern that taxpayers were deferring or avoiding tax on sales of partnership property.

Specifically, Congress was concerned about court decisions that allowed tax-free treatment in cases that were economically indistinguishable from sales of property to a partnership or another partner, and believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. See H.R. Rep. No. 432, 98th Cong. 2nd Sess. 1218 (1984) (H.R. Rep.), and S. Prt. No. 169 (Vol. I), 98th Cong. 2nd Sess. 225 (1984) (S. Prt.) (discussing Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980), and Jupiter Corp. v. United States, 2 Cl. Ct. 58 (1983), both of which involved the disguised sale of a partnership interest).

On September 30, 1992, final regulations under section 707(a)(2) (T.D. 8439, 1992-2 C.B. 126) relating to disguised sales of property to and by partnerships were published in the **Federal Register** (57 FR 44974 as corrected by 57 FR 56443) (Existing Regulations). Section 1.707-7 of the Existing Regulations was reserved for rules on disguised sales of partnership interests. On October 9, 2001, the IRS and the Treasury Department issued Notice 2001-64 (2001-2 C.B. 316), announcing that the IRS and the Treasury Department were considering issuing proposed regulations under section 707(a)(2)(B), relating to disguised sales of partnership interests. The IRS and the Treasury Department requested comments on the scope and substance of guidance concerning disguised sales of partnership interests, including any applicable safe harbors or exceptions. Written comments in response to Notice 2001-64 were received and given full consideration in drafting these proposed regulations.

Testimony of the Staff of the Joint Committee on the Enron Report (Written Testimony). In the Enron Report and the Written Testimony, the Joint Committee recommended changes to rules in the Existing Regulations that require disclosure of certain transactions. These proposed regulations include those changes and provide disclosure rules for disguised sales of partnership interests consistent with the disclosure rules in the Existing Regulations, as amended.

Explanation of Provisions

1. Framework of Rules.

Commentators responding to Notice 2001-64 generally recommended that the proposed regulations relating to disguised sales of partnership interests include a framework similar to that in the Existing Regulations, with a general rule that applies based on all of the facts and circumstances, and a variety of safe harbors and presumptions. In addition, the commentators specifically recommended that certain of the presumptions and safe harbors in the Existing Regulations be incorporated into the proposed regulations and that the treatment of liabilities under the proposed regulations largely follow the treatment of liabilities under the Existing Regulations. The IRS and the Treasury Department agree with those recommendations and, accordingly, the proposed regulations follow the form of the Existing Regulations and include rules similar to many of the rules in the Existing Regulations, with appropriate modifications.

2. General Rule.

interest. One commentator noted that, unlike the Existing Regulations, the proposed regulations would potentially be applicable whenever there are cash contributions and distributions, which are common events for most partnerships. In addition, unlike in a disguised sale of partnership property, no person, other than the partnership, participates in both of the transactions that constitute the disguised sale (contribution and distribution) and a party engaged in one of those transactions may not even be aware of the other transaction. Another commentator expressed concern that without a narrower rule, the proposed regulations could apply to many common, legitimate partnership transactions, such as the routine admission to and redemption from accounting, law, investment banking, and securities partnerships.

Under the Existing Regulations, a contribution of property by a partner to a partnership and a simultaneous distribution of money or other consideration by the partnership to the partner are treated as a disguised sale of property only if, based on all the facts and circumstances, the distribution would not have been made but for the contribution. Section 1.707-3(b)(1)(i). One of the commentators suggested that in addition to the "but for" test in the Existing Regulations, the proposed regulations provide that a contribution and distribution will constitute a disguised sale of a partnership interest only if the two transfers are "directly related." Another commentator suggested that the proposed regulations find a disguised sale of a partnership interest only where both the contribution and the distribution would not have been made but for

presumptions or safe harbors for certain transactions, such as transfers to and from professional partnerships.

The IRS and the Treasury Department agree that because many more transactions may potentially be subject to the proposed regulations, it is appropriate that the proposed regulations be narrower than the Existing Regulations. However, the IRS and the Treasury Department have concerns about the alternate tests of relatedness suggested by the commentators. Specifically, the IRS and the Treasury Department are not certain how a "directly related" test would be interpreted or applied, or whether it would be effective in narrowing the scope of the proposed rules. In addition, the IRS and the Treasury Department are concerned that certain transactions that should be treated as a disguised sale of a partnership interest would not be covered under a "double but for test." For example, assume that a prospective investor in a partnership and an existing partner who wishes to sell its partnership interest agree that upon the prospective investor's contribution to the partnership, the partnership will make a corresponding distribution to the existing partner. If the prospective investor was willing to obtain its partnership interest either by making a contribution to the partnership or by purchasing the existing partner's partnership interest, the transaction would not satisfy a "double but for test" since the contribution was not made but for the distribution. Nonetheless, the IRS and the Treasury Department believe that the transaction is economically indistinguishable from a sale of a partnership interest and should be

be treated as disguised sales of partnership interests. The IRS and the Treasury Department thus believe that the appropriate way to narrow the scope of those rules is to provide additional presumptions but adopt the same "but for" test included in the Existing Regulations.

Accordingly, the proposed regulations provide that a transfer of money, property or other consideration (including the assumption of a liability) (consideration) by a contributing partner to a partnership and a transfer of consideration by the partnership to a distributee partner constitute a sale, in whole or in part, of the distributee partner's interest in the partnership to the contributing partner only if, based on all the facts and circumstances, the distribution would not have been made but for the contribution, and, in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

3. Facts and Circumstances.

As under the Existing Regulations, the proposed regulations provide that whether two transfers constitute a disguised sale is determined based on all the facts and circumstances. The proposed regulations list a series of factors that, among others, tend to indicate the existence of a disguised sale of a partnership interest. The weight given each of the factors will depend on the circumstances of each case. Generally, the facts and circumstances existing on the date of the earliest of the transfers are the ones considered in determining if a sale exists.

interest. For example, included in the facts and circumstances in the proposed regulations are: (1) that the same property that is contributed to the partnership by the contributing partner is distributed to the distributee partner; and (2) that the partnership holds transferred property for a limited period of time, or during the period of time the partnership holds transferred property, the risk of gain or loss associated with ownership of the property is immaterial. The addition of these facts and circumstances in the proposed regulations reflects concerns expressed by commentators that a contribution of property by one partner and a distribution of different property to another partner should not form the basis of a disguised sale of a partnership interest. One commentator argued that to recharacterize those transfers as a sale of a partnership interest would require the reordering of steps or the creation of additional steps, which is impermissible under the step transaction and related doctrines. Nonetheless, the commentator acknowledged that there are situations in which the recharacterization more properly reflects the substance of the transaction.

The proposed regulations do not adopt a specific presumption or safe harbor for transactions involving transfers of different property. The IRS and the Treasury Department specifically request additional comments on whether a presumption or safe harbor for those transactions is appropriate and, if so, how any presumption or safe harbor could be narrowly tailored to cover only those transactions that clearly should not be characterized as a sale of a partnership interest.

defaulting partner to the partnership and the related transfer by the partnership to the non-defaulting partner merely restore the original economic deal intended, and should not be characterized as a sale. The IRS and the Treasury Department believe, however, that this type of transaction is difficult to distinguish from an actual sale of a partnership interest. Therefore, the proposed regulations do not include a safe harbor for these transactions but provide, as one of the relevant facts and circumstances, that the transfers are economically equivalent to a temporary loan and repayment. Similarly, one of the commentators recommended that the proposed regulations generally provide that a transfer to a partnership in the form of a loan will not serve as a predicate for a disguised sale of a partnership interest. In response to this comment, the proposed regulations include as one of the relevant facts and circumstances that the contributing partner does not have a legally enforceable right as a creditor to the return of any of the contributed consideration.

4. Presumptions and Safe Harbors.

a. In General.

The commentators generally suggested that the proposed regulations provide presumptions and safe harbors that model those contained in the Existing Regulations. Those rules generally focus on the timing, risk, and source of partnership distributions. The IRS and the Treasury Department believe that rules similar to those rules in the Existing Regulations should apply in the context of disguised sales of partnership

interests. As under the Existing Regulations, each of the presumptions in the proposed regulations may be rebutted only by facts and circumstances that clearly establish the contrary.

b. Timing of Transfers, Service Partnerships, and Liquidations.

The proposed regulations adopt an approach similar to that in the Existing Regulations regarding transfers made within two years and transfers made more than two years apart. Thus, the proposed regulations provide that a transfer of consideration by a contributing partner to a partnership and a transfer of consideration by the partnership to a distributee partner that are made within two years of each other are presumed to be a sale, and that transfers made more than two years apart are presumed not to be a sale. One commentator suggested that the timing presumptions in the proposed regulations should only apply to "extraordinary" contributions and distributions because the proposed regulations, unlike the Existing Regulations, may apply whenever there is a cash contribution to and cash distribution from a partnership, which are routine transactions for many partnerships. The IRS and the Treasury Department believe that this concern is adequately addressed by the inclusion in the proposed regulations of presumptions, discussed below, against sale treatment for: (1) transfers of consideration to and by service partnerships; and (2) guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures.

done little to promote certainty for taxpayers, and that timing presumptions are not relevant in the context of disguised sales of partnership interests because the time period that elapses between a transfer by a contributing partner and a transfer to a distributee partner does not affect whether the contributing partner will be, or the distributee partner has been, subject to the entrepreneurial risks and rewards of partnership operations.

The IRS and the Treasury Department did not follow the commentator's recommendation. Even though timing presumptions do not eliminate the need to analyze the relevant facts and circumstances, the IRS and the Treasury Department believe that timing presumptions help the IRS and taxpayers identify transactions where closer scrutiny is required and, thus, do provide some amount of certainty for taxpayers. See S. Prt. No. 169 (Vol. I), 98th Cong. 2nd Sess. 231 (1984) (suggesting that regulations provide a presumption of "relatedness" for contributions and distributions within three years.) Moreover, although the time period between transfers in the context of a disguised sale of a partnership interest is not relevant to determining whether the contributing partner and the distributee partner generally should be respected as partners in the partnership, that time period is relevant in determining whether the contributing partner and the distributee partner should both be respected as owning an interest in the partnership during that time period or whether the distributee partner should be treated as having sold its interest to the contributing partner.

producing factor are presumed not to be a sale. This presumption takes into account that partners frequently enter and exit service partnerships and, in most cases, those transactions are factually unrelated to each other and should not be treated as a disguised sale of a partnership interest. One commentator also suggested that the proposed regulations provide presumptions or safe harbors for other types of partnerships, including securities partnerships and partnerships involved in staged closings. The IRS and the Treasury Department specifically request additional comments on whether the proposed regulations should include presumptions or safe harbors for partnerships other than service partnerships, and if so, how to appropriately define those categories of partnerships.

The IRS and the Treasury Department believe the abuse that section 707(a)(2)(B) was intended to address typically is not present in situations involving complete liquidations of partners' partnership interests for money. Accordingly, in the interest of administrative convenience, the proposed regulations provide that, notwithstanding the presumption relating to transfers within two years, a transfer of money, including marketable securities that are treated as money under section 731(c)(1), to a distributee partner in liquidation of that partner's entire interest in the partnership is presumed not to be part of a disguised sale of that interest. However, the IRS and the Treasury Department recognize that there are instances in which a liquidating distribution may properly be characterized as part of a disguised sale of a

c. Guaranteed Payments, Preferred Returns, Operating Cash Flow Distributions, and Qualified Reimbursements.

As recommended by the commentators, the proposed regulations provide that rules similar to those provided in §1.707-4 of the Existing Regulations concerning guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures apply (notwithstanding the presumption relating to transfers made within two years of each other) to determine the extent to which a transfer to a distributee partner is treated as part of a sale of the distributee partner's interest in the partnership to the contributing partner. The IRS and the Treasury Department agree that inclusion of those rules in the proposed regulations is appropriate in order to distinguish between distributions to partners that occur in the ordinary course of business and distributions to partners that are part of a disguised sale.

5. Liabilities.

The proposed regulations generally follow the approach of the Existing Regulations with respect to the treatment of liabilities. Thus, the proposed regulations provide, as suggested by the commentators, that deemed contributions to and distributions from a partnership under section 752 resulting from reallocations of partnership liabilities among partners are not treated as transfers of consideration. However, if a partnership assumes a liability of a partner, the partnership is treated as

treated as transferring consideration to the partnership to the extent that the amount of the liability assumed exceeds the partner's share of that liability immediately before the assumption. The rules in the proposed regulations relating to a partner's share of a partnership liability, including the effect of a subsequent reduction in a partner's share of a partnership liability, follow those rules in the Existing Regulations. The proposed regulations also include rules with respect to debt-financed transfers of consideration by partnerships that model the rules in the Existing Regulations.

Unlike the Existing Regulations, the proposed regulations do not include any special rules for qualified liabilities. The IRS and the Treasury Department believe that the inclusion of those special rules in the Existing Regulations is appropriate because, otherwise, any contribution of property to a partnership subject to a liability could be recharacterized as a disguised sale of property. In contrast, under the proposed regulations, a contribution of encumbered property alone would not be subject to recharacterization as a disguised sale of a partnership interest. Rather, a contribution of encumbered property would have to be related to a contribution of consideration by another partner in order for disguised sale treatment to apply. Nonetheless, the IRS and the Treasury Department specifically request comments on whether the proposed regulations should include rules similar to those in the Existing Regulations for qualified liabilities, and if so, whether and how those rules should be modified to address issues

provides that changes in the partners' shares of partnership liabilities or assumptions of liabilities may be treated as a transfer of consideration in a sale of a partnership interest based on the pertinent facts and circumstances, including that the liability is transitory, that one partner bears a disproportionate share of the economic risk for the liability or receives an increase or decrease in its interest in partnership profits as a result of the assumption of that liability or otherwise, or that the transactions are undertaken pursuant to an overall integrated plan. Under the anti-abuse rule, for example, the combination of a new borrowing by a partnership equal to the capital account of the exiting partner, the guarantee of this new indebtedness by a nominally capitalized affiliate of another partner in the partnership, and the use of the debt proceeds to purchase a nonmarketable security that is then immediately distributed to the exiting partner, may be recast as a sale and purchase of the exiting partner's interest in the partnership, rather than as a partnership borrowing and distribution in liquidation of the exiting partner's interest in the partnership. Comments are requested on this proposed anti-abuse rule, including examples of other situations where application of this rule would be appropriate.

6. Treatment of Transfers as a Sale.

If a transfer of consideration by a contributing partner to the partnership and a transfer of consideration by the partnership to a distributee partner are treated as part of

timing of the sale that are similar to those in the Existing Regulations. Specifically, the proposed regulations provide that the sale is considered to take place on the date of the earliest of the transfers. If the distribution occurs before the contribution, the partners and the partnership are treated as if, on the date of the sale, the contributing partner transferred an obligation to deliver the contributed consideration to the partnership in exchange for the distributed consideration, and the contributing partner transferred the distributed consideration to the distributee partner in exchange for the distributee partner's partnership interest. If the distribution occurs after the contribution, the partners and the partnership are treated as if, on the date of the sale, the contributing partner transferred the contributed consideration to the partnership in exchange for an obligation of the partnership to deliver the distributed consideration, and the contributing partner transferred that obligation to the distributee partner in exchange for the distributee partner's partnership interest.

The IRS and the Treasury Department intend that the deemed transactions that are treated as occurring as described in the immediately preceding paragraph result in actual tax consequences to the partnership, the purchasing partner(s) and the selling partner(s). For example, where the consideration actually transferred by the contributing partner to a partnership is different than the actual consideration later transferred from the partnership to the distributee partner, there may be tax

disguised sale, e.g., time value of money, bases of properties, and gain or loss recognition to the partnership or partners (including the potential application of section 267 or 707), or comments providing an alternative approach for accounting for disguised sales of partnership interests that does not result in current tax consequences to the parties.

The proposed regulations also provide rules relating to the amount of the sale and the inclusion of liability relief in the amount realized on the sale. Specifically, with respect to the amount of the sale, the proposed regulations provide that the distributee partner is treated as selling to the contributing partner a partnership interest with a value equal to the lesser of the distributee partner's consideration and the contributing partner's consideration. For this purpose, simultaneous transfers of consideration by more than one contributing partner to a partnership, or by a partnership to more than one distributee partner, are aggregated. In those cases, each contributing partner is presumed to have purchased a fractional share of the partnership interest(s) sold, and each distributee partner is presumed to have sold its fractional share of the total partnership interest(s) sold. In addition, although the proposed regulations provide that deemed contributions to and distributions from a partnership under section 752 resulting from reallocations of partnership liabilities among partners are not treated as transfers of consideration, the proposed regulations clarify that the amount realized by a distributee partner on the sale of the distributee partner's interest in the partnership

The proposed regulations also address issues relating to the application of certain rules that may overlap. First, the proposed regulations provide that if a portion of a transfer of consideration by a partnership to a distributee partner is not treated as part of a sale of the distributee partner's interest in the partnership, but as a distribution to the distributee partner under section 731, and the sale is treated as occurring on the same date as the distribution, then the distribution is treated as occurring immediately following the sale. Thus, the portion of the distribution that is treated as a distribution is not taken into account for purposes of computing the distributee partner's basis in its partnership interest prior to the disguised sale of the interest. In addition, the proposed regulations provide that the rules for disguised sales of property apply before the rules of the proposed regulations. In some cases, this approach may simplify the tax consequences of the disguised sale, for example by preventing the occurrence of technical terminations of partnerships under section 708(b)(1)(B) or by preventing the need for a basis adjustment under section 743(b).

Finally, the proposed regulations clarify whether the rules apply to certain transfers that occur upon the termination or formation of a partnership. The proposed regulations do not apply to transfers incident to the formation of a partnership, although these transfers may be subject to recharacterization as a disguised sale of property under the Existing Regulations. The proposed regulations also do not apply to transfers resulting from a termination of a partnership under section 708(b)(1)(B). However, the

7. Disclosure.

In the Enron Report and the Written Testimony, the Joint Committee recommended that the period for which disclosure of a transaction is required under the disguised sale rules should be extended beyond two years. The Committee further suggested that a seven year disclosure period could make the facts and circumstances determination both more likely to occur and easier for the IRS to administer. To effect this recommendation, the proposed regulations would amend §§1.707-3(c)(2) and 1.707-6(c) of the Existing Regulations to extend the disclosure requirement to the specified events occurring within seven years instead of two years.

The disclosure requirement under §1.707-5(a)(7)(ii), regarding a qualified liability incurred within two years prior to a transfer of property, remains unchanged, given that liabilities incurred after two years are presumed beyond rebuttal to be qualified liabilities. However, the proposed regulations would add a new requirement to both §§1.707-5 and -6 of the Existing Regulations, relating to the disclosure of the assumption of or taking subject to liabilities. Specifically, §1.707-5(a)(8) of the proposed regulations would require disclosure if a partner transfers property to a partnership, and the partnership assumes or takes property subject to a liability of the partner (whether or not the liability is qualified) within a seven-year period (without regard to the order of the transactions), and the partner treats the transactions as other than as a sale for tax purposes. Similarly, §1.707-6(c)(3) of the proposed regulations would require disclosure if a

treats the transactions as other than as a sale for tax purposes. These disclosure requirements were added because of a concern that taxpayers are taking unwarranted positions regarding a partner's share of partnership liabilities before or after an assumption of or taking subject to a partnership or partner liability.

Finally, the proposed regulations would amend the provision in §1.707-8(c) to clarify who is required to disclose under the disguised sale rules. The amended paragraph provides that the required disclosure must be made by any person who makes a transfer that is required to be disclosed, and that the persons who are required to disclose may designate by written agreement a single person to make the disclosure. However, the designation of one person to make the disclosure does not relieve the other persons required to disclose from their obligation to make the disclosure, if the designated person fails to make the appropriate disclosure.

The proposed regulations provide disclosure rules for transactions that may be treated as disguised sales of partnership interests consistent with the disclosure rules in the Existing Regulations, as amended.

8. Review of Existing Regulations

In the process of drafting these proposed regulations, the IRS and the Treasury Department have become aware of certain conceptual as well as mechanical problems with the Existing Regulations and, as a result, with these proposed regulations as well. For example, the IRS and the Treasury Department are aware that taxpayers have

as referring to the fair market value of the subject property determined without regard to any qualified liability on the property within the meaning of §1.707-5(a)(6)(i)(C). As a result, reimbursements to the contributing partner have been based on the gross fair market value of the contributed property and, at the same time, the liability assumed by the partnership has been treated as a qualified liability under the rules of §1.707-5. The IRS and the Treasury Department view this transaction as abusive and intend to amend the Existing Regulations to make it clear that this result was not intended. In addition, certain transactions have come to the attention of the IRS and the Treasury Department that apply the term capital expenditure in both §1.707-5(a)(6)(i)(C) and §1.707-4(d) in a manner that was not intended by the drafters of the Existing Regulations. Others have contended that debt allocations under §1.707-5 and §1.707-6 can be accomplished that allocate the debt to a partner who is, in substance, not economically responsible for the debt either by causing guarantees of the debt to be made by nominally capitalized corporations or by specifically allocating a claimed significant partnership item. Others have used bottom-line allocations of book income under §1.704-1(b)(1)(vii) to achieve similar results. Other misuses of the Existing Regulations have come to the attention of the IRS and the Treasury Department, including the lack of full and adequate disclosure of all transactions that could be disguised sales under the Existing Regulations. The IRS and the Treasury Department intend to issue new proposed regulations dealing with both sales of property to a partnership and sales of partnership interests, and

The regulations are proposed to apply to transactions with respect to which all transfers considered part of a sale occur on and after the date these regulations are published as final regulations in the **Federal Register**. The Existing Regulations already state that a determination of disguised sale treatment for property, including a partnership interest, for the period between the effective date of section 707(a)(2) and the effective date of those regulations is to be made based on the statutory language and the guidance provided in the legislative history of section 707(a)(2). The proposed regulations clarify that the determination of disguised sale treatment for partnership interests for the period between the effective date of the Existing Regulations and these proposed regulations is to be made on the same basis.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the amount of time necessary to report the required information will be minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on all aspects of the proposed regulations. Comments are also requested on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for **[INSERT DATE]**, at **[INSERT TIME]**, in the IRS Auditorium, Seventh Floor, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments by **[INSERT DATE]** and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by **[INSERT DATE]**. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the

The principal authors of these regulations are James M. Gergurich and Deane M. Burke of the Office of the Associate Chief Counsel (Passthroughs & Special Industries), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAX

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 707(a)(2) and 26 U.S.C. 7805 * * *

Par. 2. Section 1.707-0 is amended as follows:

1. Adding an entry for §1.707-5(a)(8).
2. Revising the entry for §1.707-7.
3. Adding entries for §§1.707-7(a) through 1.707-7(k).
4. Revising the entry for §1.707-8(c).
5. Revising the entries for §§1.707-9(a) and (a)(2).

The revisions and additions read as follows:

* * * * *

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

* * * * *

§1.707-7. Disquised sales of partnership interests.

(a) Treatment of transfers as a sale.
(1) In general.
(2) Definition, timing and consequences of sale.
(i) Definition of sale.
(ii) Timing and consequences of sale.
(A) In general.
(B) Simultaneous contribution and distribution.
(C) Distribution before contribution.
(D) Distribution after contribution.
(E) Consequences of deemed transactions.
(3) Amount of sale.
(i) In general.
(ii) Aggregation of consideration.
(4) Liability relief included in amount realized on sale.
(5) Sale precedes excess distribution to distributee partner.
(6) Transfers first treated as a sale of property.
(7) Application of disguised sale rules.
(8) Certain transfers disregarded.
(b) Transfers treated as sale.
(1) In general.
(2) Facts and circumstances.
(c) Transfers made within two years presumed to be a sale.
(d) Transfers made more than two years apart presumed not to be a sale.
(e) Transfers to and by service partnerships presumed not to be a sale.
(f) Transfers of money in liquidation of a partner's interest presumed not to be a sale.
(g) Application of §1.707-4 (special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures).
(h) Other exceptions.
(i) Special rules relating to liabilities.
(1) In general.
(2) Partner liability assumed by partnership.
(3) Partnership liability assumed by partner.
(4) Partner's share of liability.

(B) Debt-financed transfers made pursuant to a plan.
(1) In general.
(2) Special rule.
(C) Reduction of partner's share of liability.
(7) Share of liability where assumption accompanied by transfer of money.
(8) Anti-abuse rule.
(j) Disclosure rules.
(k) Examples.

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§1.707-8 Disclosure of certain information.

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(c) Parties required to disclose.

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§1.707-9 Effective dates and transitional rules.

(a) Sections 1.707-3 through 1.707-7.
(1)* * *
(2) Transfers occurring before effective dates.

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Par. 3. In §1.707-3, the heading for paragraph (c)(2) and the text in paragraph (c)(2)(i) are revised by removing the language "two" and adding "seven" in its place.

Par. 4. In §1.707-5, new paragraph (a)(8) is added.

The addition reads as follows:

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

(a) * * *

(i) A partner transfers property to a partnership, and the partnership assumes or takes property subject to a liability of the partner (qualified, as described in §1.707-5(a)(6), or other than qualified) within a seven-year period (without regard to the order of the transactions);

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

(iii) The transactions are not disclosed under paragraph (a)(7)(ii) of this section.

* * * * *

Par. 5. In §1.707-6 is amended as follows:

1. Revising paragraph (c) introductory text.

2. Revising paragraph (c)(1) by removing the language "two" and adding "seven" in its place.

3. Adding new paragraph (c)(3).

The revisions and addition read as follows:

§1.707-6 Disguised sales of property by partnership to partners; general rule.

* * * * *

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

* * * * *

order of the transactions), the partnership treats the transactions as other than as a sale for tax purposes, and the transactions are not disclosed under paragraph (c)(2) of this section.

* * * * *

Par. 6. Section 1.707-7 is amended to read as follows:

* * * * *

§1.707-7 Disguised sales of partnership interests.

(a) Treatment of transfers as a sale--(1) In general. Except as otherwise provided in this section, if a transfer of money, property or other consideration (including the assumption of a liability) (consideration) by a partner (contributing partner) to a partnership and a transfer of consideration by the partnership to another partner (distributee partner) are described in paragraph (b)(1) of this section, the transfers are treated as a sale, in whole or in part, of the distributee partner's interest in the partnership to the contributing partner. For purposes of this section, the term transfer refers to a portion of a single transfer or to one or more transfers.

(2) Definition, timing and consequences of sale--(i) Definition of sale. For purposes of this section, the use of the term sale (or any variation of that word) to refer to a transfer of consideration by a contributing partner to a partnership and a transfer of consideration by the partnership to a distributee partner means a sale or exchange, in whole or in part, of the distributee partner's interest in the partnership to the contributing

section are treated as a sale for all purposes of the Internal Revenue Code (e.g., sections 453, 483, 704, 708, 743, 751, 1001, 1012 and 1274).

(ii) Timing and consequences of sale--(A) In general. For purposes of this section, a transfer is treated as occurring on the date of the actual transfer, or if earlier, on the date that the transferor agrees in writing to make the transfer. The sale is considered to take place on the date of the earliest of the transfers.

(B) Simultaneous contribution and distribution. If the transfer of consideration by the contributing partner to the partnership and the transfer of consideration by the partnership to the distributee partner are simultaneous and the consideration transferred is not the same, the partners and the partnership are treated as if, on the date of the sale, the contributing partner transferred that partner's consideration to the partnership in exchange for the consideration to be transferred to the distributee partner (distributed consideration) and then the contributing partner transferred the distributed consideration to the distributee partner in exchange for all or a portion of the distributee partner's interest in the partnership. If the transfer of consideration by the contributing partner and the transfer of consideration to the distributee partner are simultaneous and the consideration transferred is the same, the partners and the partnership are treated as if, on the date of the sale, the contributing partner transferred the consideration directly to the distributee partner in exchange for all or a portion of the distributee partner's interest in the partnership.

on the date of the sale, the contributing partner transferred an obligation to deliver the contributed consideration to the partnership in exchange for the distributed consideration and then the contributing partner transferred the distributed consideration to the distributee partner in exchange for all or a portion of the distributee partner's interest in the partnership. On the date of the actual transfer of the contributed consideration, the contributing partner and the partnership are treated as if the contributing partner satisfied its obligation to deliver the contributed consideration to the partnership.

(D) Distribution after contribution. If the transfer of consideration by the partnership to the distributee partner occurs after the transfer of consideration by the contributing partner to the partnership, the partners and the partnership are treated as if, on the date of the sale, the contributing partner transferred the contributed consideration to the partnership in exchange for an obligation of the partnership to deliver the distributed consideration and then the contributing partner transferred that obligation to the distributee partner in exchange for all or a portion of the distributee partner's interest in the partnership. On the date of the actual transfer of the distributed consideration, the distributee partner and the partnership are treated as if the partnership satisfied its obligation to deliver the distributed consideration to the distributee partner.

(E) Consequences of deemed transactions. [Reserved.]

with a value equal to the lesser of the distributee partner's consideration and the contributing partner's consideration.

(ii) Aggregation of consideration. For purposes of paragraph (a)(3)(i) of this section, simultaneous transfers of consideration by more than one contributing partner to a partnership or by a partnership to more than one distributee partner are aggregated. In those cases--

(A) Each contributing partner is presumed to have purchased that fraction of each partnership interest(s) sold equal to--

(1) The amount of consideration transferred by that partner to the partnership, divided by

(2) The aggregate consideration transferred by all contributing partners to the partnership; and

(B) Each distributee partner is presumed to have sold that fraction of the total partnership interest(s) sold equal to--

(1) The amount of consideration transferred by the partnership to that partner, divided by

(2) The aggregate consideration transferred by the partnership to all distributee partners.

(4) Liability relief included in amount realized on sale. The amount realized by a

(5) Sale precedes excess distribution to distributee partner. If a portion of a transfer of consideration by a partnership to a distributee partner is not treated as part of a sale of the distributee partner's interest in the partnership, but as a distribution to the distributee partner under section 731, and the sale is treated as occurring on the same date as the distribution, then the distribution is treated as occurring immediately following the sale.

(6) Transfers first treated as a sale of property. To the extent that a transfer of consideration by a contributing partner to a partnership or a transfer of consideration by a partnership to a distributee partner is treated as a sale of property under §1.707-3(a), such transfer is not treated as a sale under this section.

(7) Application of disguised sale rules. Except as otherwise provided in paragraph (a)(8) of this section, the rules of this section apply to transfers to and from a partnership even if, after the application of the rules of this section, it is determined that the partnership has terminated under section 708(b)(1)(A).

(8) Certain transfers disregarded. In applying the rules of this section, transfers resulting from a termination of a partnership under section 708(b)(1)(B),and transfers incident to the formation of a partnership, are disregarded. However, transfers incident to the formation of a partnership may be transfers to which §1.707-3(a) applies.

(b) Transfers treated as sale--(1) In general. A transfer of consideration by a

(i) The transfer of consideration by the partnership to the distributee partner would not have been made but for the transfer of consideration to the partnership by the contributing partner; 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 consideration by a contributing partner to a partnership and a transfer of consideration by the partnership to a distributee partner constitute a sale 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 the transfers are the ones considered in determining if 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 all or any portion of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the person receiving the subsequent transfer has a legally enforceable right to the transfer or that the right to receive the transfer is secured in any manner, taking into account the period for which it is secured;

(iii) That the same property that is contributed to the partnership by the

(iv) That partnership distributions, allocations or control of operations is designed to effect an exchange of the benefits and burdens of ownership of transferred property (including a partnership interest);

(v) That the partnership holds transferred property for a limited period of time, or during the period of time the partnership holds transferred property, the risk of gain or loss associated with ownership of the property is immaterial;

(vi) That the transfer of consideration by the partnership to the distributee partner is disproportionately large in relationship to the distributee partner's general and continuing interest in partnership profits;

(vii) That the distributee partner has no obligation to return or repay the consideration to the partnership, or has an obligation to return or repay the consideration due at such a distant point in the future that the present value of that obligation is small in relation to the amount of consideration transferred by the partnership to the distributee partner;

(viii) That the contribution by the contributing partner or distribution to the distributee partner is not made pro rata;

(ix) That there were negotiations between the contributing partner and the distributee partner (or between the partnership and each of the contributing and distributee partners with each partner being aware of the negotiations with the other partner) concerning any transfer of consideration;

(xi) That the distributee partner had the ability to prevent the transfer by the contributing partner;

(xii) That the transfer to the distributee partner was reimbursement for a capital contribution previously made by the distributee partner to satisfy another partner's obligation to make a capital contribution, and that the distributee partner did not have, at the time the previous capital contribution was made, a legally enforceable right as a creditor to reimbursement against either the partnership or the defaulting partner; and

(xiii) That the contributing partner does not have a legally enforceable right as a creditor to the return of any of the contributed consideration.

(c) Transfers made within two years presumed to be a sale. For purposes of this section, if within a two-year period a contributing partner transfers consideration to a partnership and the partnership transfers consideration to a distributee partner (without regard to the order of the transfers), the transfers are presumed to be a sale, in whole or in part, of the distributee partner's interest in the partnership to the contributing partner unless the facts and circumstances clearly establish that the transfers do not constitute a sale.

(d) Transfers made more than two years apart presumed not to be a sale. For purposes of this section, if a transfer of consideration by a contributing partner to a partnership and the transfer of consideration by the partnership to a distributee partner (without regard to the order of the transfers) occur more than two years apart, the

(e) Transfers to and by service partnerships presumed not to be a sale. Notwithstanding the presumption set forth in paragraph (c) of this section, for purposes of this section, transfers of consideration to and by a partnership in which capital is not a material income-producing factor are presumed not to be a sale, in whole or in part, of the distributee partner's interest in the partnership to the contributing partner unless the facts and circumstances clearly establish that the transfers constitute a sale. See §1.704-1(e)(1)(iv) for the definition of capital as a material income-producing factor.

(f) Transfers of money in liquidation of a partner's interest presumed not to be a sale. Notwithstanding the presumption set forth in paragraph (c) of this section, for purposes of this section, if a partnership transfers money, including marketable securities that are treated as money under section 731(c)(1), to a distributee partner in liquidation of the distributee partner's interest in the partnership, the transfer is presumed not to be a sale, in whole or in part, of the distributee partner's interest in the partnership to the contributing partner unless the facts and circumstances clearly establish that the transfer is part of a sale. See §1.761-1(d) for the definition of the term liquidation of a partner's interest.

(g) Application of §1.707-4 (special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures). Rules similar to those provided in §1.707-4 apply notwithstanding the presumption set forth in paragraph (c) of this section to determine the extent to which a

(h) Other exceptions. The Commissioner may provide by guidance published in the Internal Revenue Bulletin that other transfers are not treated as part of a sale for purposes of section 707(a)(2)(B) and these regulations.

(i) Special rules relating to liabilities--(1) In general. For purposes of this section, deemed contributions to and distributions from a partnership under section 752 resulting from reallocations of partnership liabilities among partners are not treated as transfers of consideration. Under paragraph (a)(4) of this section, the preceding sentence does not apply if the transaction is otherwise treated as a sale of a partnership interest under the rules of this section.

(2) Partner liability assumed by partnership. For purposes of this section, if a partnership assumes a liability of a partner, 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 (determined under the rules of paragraphs (i)(4) and (5) of this section) immediately after the partnership assumes the liability. For purposes of this section, a partnership is treated as assuming a liability of a partner to the extent provided in §§1.752-1(d) and (e). For purposes of this paragraph (i)(2), if the partnership assumes the liabilities of more than one partner pursuant to a plan, a partner's share of the liabilities assumed by the partnership pursuant to that plan immediately after the transfers equals the sum of that partner's shares of the liabilities assumed by the partnership pursuant to the plan. The preceding sentence does not

(3) Partnership liability assumed by partner. For purposes of this section, if a partner assumes a liability of a partnership, the partner is treated as transferring consideration to the partnership to the extent that the amount of the liability exceeds the partner's share of that liability (determined under the rules of paragraph (i)(4) of this section) immediately before the partner assumes the liability. For purposes of this section, a partner assumes a partnership liability to the extent provided in §§1.752-1(e) and 1.704-1(b)(2)(iv)(c). For purposes of this paragraph (i)(3), if more than one partner assumes 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 assumed by the partner pursuant to the plan exceed the partner's share of all of those liabilities immediately before the assumption. The preceding sentence does not apply to any liability assumed by a partner with a principal purpose of reducing the extent to which any other liability assumed by a partner is treated as a transfer of consideration under this paragraph (i)(3).

(4) 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). See §1.752-1(h).

liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under §1.752-1(a). See §1.752-1(h).

(5) Reduction of partner's share of liability. For purposes of this section, a partner's share of a liability, immediately after a partnership assumes 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 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 the liability is treated as part of a sale under this section.

(6) Treatment of debt-financed transfers of consideration by partnerships--(i) In general. For purposes of this section, if a 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 consideration to a partner made within 90 days of incurring the liability, the transfer of consideration to the partner is taken into account only to the extent that the amount of consideration transferred exceeds that partner's allocable share of the partnership liability.

(ii) Partner's allocable share of liability--(A) In general. A partner's allocable share of a partnership liability for purposes of paragraph (i)(6)(i) of this section equals the amount obtained by multiplying the partner's share of the liability (as defined in

(2) The total amount of the liability.

(B) Debt-financed transfers made pursuant to a plan--(1) In general. Except as provided in paragraph (i)(6)(ii)(C) 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 (i)(6)(i) 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 (i)(4) of this section) by the fraction obtained by dividing--

(a) The portion of those liabilities that is allocable under §1.163-8T to the consideration transferred to the partners pursuant to the plan; by

(b) The total amount of those liabilities.

(2) Special rule. Paragraph (i)(6)(ii)(B)(1) of this section does not apply to any transfer of consideration to a partner that is made with a principal purpose of reducing the extent to which any transfer is taken into account under paragraph (i)(6)(i) of this section.

(C) Reduction of partner's share of liability. For purposes of paragraph (i)(6)(ii) of this section, a partner's share of a liability is determined by taking into account a subsequent reduction in the partner's share if--

(1) It is anticipated that the partner's share of the liability that is allocable to a

(2) 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.

(7) Share of liability where assumption accompanied by transfer of money. For purposes of paragraph (i)(2) of this section, if pursuant to a plan a partner pays or contributes money to the partnership and the partnership assumes one or more liabilities of the partner, the amount of those liabilities that the partnership is treated as assuming is reduced (but not below zero) by the money transferred. Similarly, for purposes of paragraph (i)(3) of this section, if pursuant to a plan a partnership pays or distributes money to a partner and the partner assumes one or more liabilities of the partnership, the amount of those liabilities that the partner is treated as assuming is reduced (but not below zero) by the money transferred.

(8) Anti-abuse rule. For purposes of this section, changes in the partners' shares of partnership liabilities or assumptions of liabilities may be treated as a transfer of consideration in a sale of a partnership interest, notwithstanding any other rule in this section, based on the pertinent facts and circumstances. Those facts and circumstances include, but are not limited to, that the liability is transitory, that one partner bears a disproportionate share of the economic risk for the liability or receives an increase or decrease in its interest in partnership profits as a result of the assumption of that liability or otherwise, or that the transactions are undertaken

partnership and the partnership transfers consideration to a distributee partner within a seven-year period (without regard to the order of the transfers), the partners treat the transfers other than as a sale for tax purposes, and the transfer of consideration to the distributee 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).

(k) Examples. The following examples illustrate the application of this section. For purposes of these examples, assume that the contributions and distributions would otherwise be respected as such and that, as a result, sections 721(b), 751(b), 704(c)(1)(B), 737, and §1.707-3 do not otherwise apply.

Example 1. Treatment of simultaneous transfers as a sale by a distributee partner to a contributing partner. (i) A and B each owns a 50% interest in partnership AB. AB holds Blackacre, real property with a fair market value of $400. AB has no liabilities. On May 25, 2004, C transfers $100 in cash to AB in exchange for an interest in AB. Simultaneously, AB distributes $100 in cash to A.

(ii) Because C's transfer of $100 to AB and AB's distribution of $100 to A occurred within two years, the transfers are presumed to be a sale of a portion of A's interest in AB to C under paragraph (c) of this section, unless the facts and circumstances clearly establish otherwise. There are no facts that rebut the presumption of sale treatment or support the application of any of the presumptions against sale treatment provided in paragraphs (e), and (f), or (g) of this section. Thus, the transfers are treated as a sale of a portion of A's interest in the AB partnership to C. Under paragraph (a)(3)(i) of this section, the value of the partnership interest that A is treated as selling to C equals the lesser of the consideration transferred by AB to A or the consideration transferred by C to AB. C transferred $100 to AB, and A received $100 from AB. Thus, A is treated as having sold an interest in AB with a value of $100

(ii) Because AB's distribution of $100 to A and C's transfer of $50 to the AB occurred within two years, the transfers are presumed to be a sale of a portion of A's interest in AB to C under paragraph (c) of this section, unless the facts and circumstances clearly establish otherwise. There are no facts that rebut the presumption of sale treatment or support the application of any of the presumptions against sale treatment provided in paragraphs (e), (f), or (g) of this section. Thus, the transfers are treated as a sale of a portion of A's interest in AB to C. Under paragraph (a)(2)(ii)(A) of this section, the sale takes place on the date of the earliest of the transfers, March 25, 2004, upon AB's distribution of $100 to A. Under paragraph (a)(3)(i) of this section, the value of the partnership interest that A is treated as selling to C equals the lesser of the consideration transferred by AB to A or the consideration transferred by C to AB. C transferred $50 to AB, and A received $100 from AB. Thus, A is treated as having sold an interest in AB with a value of $50 to C. Under paragraph (a)(2)(ii)(C), because the distribution to A precedes the contribution by C, A and C and AB are treated as if, on March 25, 2004, C issued a note to the partnership in exchange for $50 and then C transferred $50 to A in exchange for a portion of A's interest in AB with a value of $50. On May 25, 2004, when C actually transfers $50 to AB, C is treated as satisfying the note it issued to AB. A also is treated as receiving, in its capacity as a partner, a distribution from AB to which section 731 applies of $50 ($100 distribution - $50 amount of sale). Under paragraph (a)(5) of this section, the distribution is treated as occurring immediately following the sale.

Example 3. Treatment of simultaneous transfers as a sale by a distributee partner to more than one contributing partner. (i) E and F each owns a 50% interest in partnership EF. EF holds a building with a fair market value of $500. EF has no liabilities. On May 25, 2004, G and H each transfer $50 in cash to EF in exchange for an interest in EF. Simultaneously, EF distributes $100 in cash to E.

(ii) Because each of G's and H's transfers of $50 to EF and EF's distribution of $100 to E occurred within two years, G's transfer to EF and EF's distribution to E and H's transfer to EF and EF's distribution to E are presumed to be a sale of a portion of E's interest in the EF partnership to G and H, respectively, under paragraph (c) of this section, unless the facts and circumstances clearly establish otherwise. There are no facts that rebut the presumption of sale treatment or support the application of any of the presumptions against sale treatment provided in paragraphs (e), (f), or (g) of this section. Thus, the transfers are treated as a sale of a portion of E's interest in EF to G and H, respectively. Under paragraph (a)(3)(i) of this section, the value of the partnership interest that E is treated as selling to G and H equals the lesser of the consideration transferred by EF to E or the consideration transferred by G and H to EF.

interest sold that is equal to G's amount transferred ($50) divided by the aggregate amount transferred by G and H ($100), or ½. H also is presumed to have purchased the fraction of E's partnership interest sold equal to H's amount transferred ($50) divided by the aggregate amount transferred by G and H ($100), or ½. Thus, G and H each is treated as having purchased a fraction of E's partnership interest that is equal to $50.

Example 4. Treatment of non-simultaneous transfers as a sale by a distributee partner to more than one contributing partner. (i) The facts are the same as in Example 3, except that EF distributes $75 in cash to E on May 1, 2003. In addition, G transfers $50 in cash to EF on March 25, 2004, and H transfers $50 in cash to EF on May 25, 2004, each in exchange for an interest in EF.

(ii) Because each of G's and H's transfers of $50 to EF and EF's distribution of $75 to E occurred within two years, G's transfer to EF and EF's distribution to E and H's transfer to EF and EF's distribution to E are presumed to be a sale of a portion of E's interest in EF to G and H, respectively, under paragraph (c) of this section, unless the facts and circumstances clearly establish otherwise. There are no facts that rebut the presumption of sale treatment or support the application of any of the presumptions against sale treatment provided in paragraphs (e), (f), or (g) of this section. Thus, the transfers are treated as a sale of a portion of E's interest in EF to G and H, respectively. Under paragraph (a)(2)(ii)(A) of this section, the sale takes place on the date of the earliest of the transfers, or on May 1, 2003, upon EF's distribution of $75 to E. Under paragraph (a)(3)(i) of this section, the value of the partnership interest that E is treated as selling to G and H equals the lesser of the consideration transferred by G and H to EF or the consideration transferred by EF to E. Because the transfers made by G and H were not simultaneous, the transfers are not aggregated. Rather, in accordance with paragraph (a)(2)(ii)(A) of this section, the transfers are considered in the order in which they were made. The value of the partnership interest that E is treated as selling to G equals $50, the lesser of G's $50 transfer to EF and the $75 E received from EF. The value of the partnership interest that E is treated as selling to H equals $25, the lesser of the remaining amount of the distribution to E, $25 ($75 - $50 = $25), and H's $50 transfer to EF. H also is considered to have contributed to EF, in H's capacity as a partner, $25 ($50 contribution - $25 amount of sale) to which section 721 applies.

Example 5. Operation of presumption for complete liquidation of a partner for money. (i) A and B each owns a 50% interest in partnership AB. AB holds marketable securities with a fair market value of $200. AB has no liabilities. On April 1, 2004, C transfers $100 in cash to AB in exchange for an interest in AB. Simultaneously, AB

under paragraph (f) of this section, notwithstanding the presumption set forth in paragraph (c) of this section, AB's transfer of marketable securities to A in liquidation of A's interest in AB is presumed not to be a sale of A's partnership interest to C, unless the facts and circumstances clearly establish otherwise. If, however, one of the exceptions under section 731(c)(3) applies to the $100 of marketable securities distributed to A, the securities would not be treated as money for purposes of section 731(a)(1), and the presumption against sale treatment under paragraph (f) of this section would not apply.

Example 6. Transfers that would otherwise be treated as both a sale of property and a sale of a partnership interest. (i) C and D each owns a 50% interest in partnership CD. CD holds Blackacre, real property with a fair market value of $2000. CD has no liabilities. On June 1, 2004, E transfers $500 in cash to CD in exchange for an interest in CD. Immediately after E's transfer, C transfers Redacre to CD, and CD distributes $500 in cash to C. At the time of the transfers, Redacre has a fair market value of $250.

(ii) Because E's transfer of $500 to CD and CD's distribution of $500 to C occurred within two years, the transfers are presumed to be a sale of a portion of C's interest in CD to E under paragraph (c) of this section, unless the facts and circumstances clearly establish otherwise. There are no facts that rebut the presumption of sale treatment or support the application of any of the presumptions against sale treatment provided in paragraphs (e), (f), or (g) of this section. Thus, the transfers are treated as a sale of a portion of C's interest in CD to E. However, because C's transfer of Redacre to CD and CD's transfer of $500 to C occurred within two years, under §1.707-3(c), the transfers are presumed to be a sale of Redacre by C to CD. Under paragraph (a)(6) of this section, transfers that are in part a sale of a partnership interest and in part a sale of property are treated, first, as part of a sale of property. Thus, C's transfer of Redacre to CD and $250 of CD's $500 distribution to C are treated, first, as a sale of Redacre by C to CD for $250. Although the $250 distributed to C that is treated as part of a sale of Redacre is not treated as part of a sale of C's interest in CD to E, the remaining $250 distributed to C is treated as part of a sale of C's interest in CD to E. The value of the partnership interest that C is treated as selling to E equals $250, the lesser of E's $500 transfer to CD and the remaining $250 C received from CD. E also is considered to have contributed to CD, in E's capacity as a partner, $250 ($500 contribution - $250 amount of sale) to which section 721 applies.

Example 7. Treatment of simultaneous transfers as a sale by a distributee partner where partnership has nonrecourse liabilities. (i) A and B each owns a 50%

$100 to AB in exchange for an interest in AB. On the same date, A receives a distribution of $200 from AB. Following the contribution and distribution, according to the amended partnership agreement, B and C will each have a 40% interest in the profits of AB, and A will have a 20% interest in partnership profits.

(ii) For purposes of determining whether the transfers constitute a disguised sale of A's or B's interest in AB, the $360 liability is ignored because no partner assumes the liability. Because C's transfer of $100 to AB and AB's distribution of $200 to A occurred within two years, the transfers are presumed to be a sale of a portion of A's interest in AB to C, under paragraph (c) of this section, unless the facts and circumstances clearly establish otherwise. There are no facts that rebut the presumption of sale treatment or support the application of any of the presumptions against sale treatment provided in paragraphs (e), (f), or (g) of this section. Thus, the transfers are treated as a sale of a portion of A's interest in AB to C. Under paragraph (a)(3)(i) of this section, the value of the partnership interest that A is treated as selling to C equals the lesser of the consideration transferred by AB to A or the consideration transferred by C to AB. C transferred $100 to AB, and A received $200 from AB. Thus, A is treated as having sold an interest in AB with a value of $100 to C. Under paragraph (a)(4) of this section, the amount realized by A on the sale of its partnership interest includes any reduction in A's share of the $360 partnership liability. Before the contribution and distribution, A's share of the nonrecourse liability under §1.752-3(a)(3) was $180 (50% of the $360 liability). Following the transfers, under §1.752-3(a)(3), A's share of the liability was $72 (because A's partnership interest was reduced to 20%). Thus, A's amount realized on the sale of its partnership interest equals $100 plus the reduction in A's share of the $360 partnership liability of $108 ($180 - $72), or $208. A also is treated as receiving, in its capacity as a partner, a distribution from AB to which section 731 applies of $100 ($200 distribution - $100 amount of sale). Under paragraph (a)(5) of this section, the distribution is treated as occurring immediately following the sale.

Example 8. Treatment of simultaneous transfers as a sale by a distributee partner where partnership has recourse liabilities that are assumed by a contributing partner. (i) The facts are the same as those in Example 7, except that AB does not make a distribution to A but does assume an $80 recourse liability of A's on January 1, 2003.

(ii) As in Example 7, the $360 liability is ignored for purposes of determining whether the transfers constitute a sale of A's or B's interest in AB because no partner assumes the $360 liability. However, AB's assumption of A's $80 recourse liability is treated as a transfer of consideration to A to the extent the amount of the liability

circumstances clearly establish otherwise. There are no facts that rebut the presumption of sale treatment or support the application of any of the presumptions against sale treatment provided in paragraphs (e), (f), or (g) of this section. Thus, the transfers are treated as a sale of a portion of A's interest in AB to C. Under paragraph (a)(3)(i) of this section, the value of the partnership interest that A is treated as selling to C equals the lesser of the consideration transferred by AB to A or the consideration transferred by C to AB. C transferred $100 to AB, and A received $64 from AB. Thus, A is treated as having sold an interest in AB with a value of $64 to C. Under paragraph (a)(4) of this section, the amount realized by A on the sale of its partnership interest includes the $108 reduction in A's share of the $360 partnership liability. Thus, A's amount realized on the sale of its partnership interest equals $64 plus the $108 reduction in A's share of the $360 partnership liability, or $172. C also is considered to have contributed to CD, in C's capacity as a partner, $36 ($100 contribution - $64 amount of sale) to which section 721 applies.

Example 9. Operation of the anti-abuse rule. (i) X and Y each owns a 50% interest in income, losses, and profits of general partnership XY. XY holds Blackacre, real property with a fair market value of $1,000. XY has no liabilities. X and Y each has a capital account in XY of $500. In 2004, X decides it would like to sell its entire interest in XY to Y. To avoid disguised sale treatment on the transfer of X's partnership interest to Y, the partners devise and execute the following plan. On June 1, 2004, in contemplation of X's exit from XY, Y causes Y Affiliate to be admitted to XY as an additional partner in exchange for a nominal contribution of capital to XY. Y Affiliate is a newly formed corporation that Y formed with a minimal contribution of capital for the sole purpose of engaging in the described transaction. On that same date, XY also borrows $500 from Bank, an unrelated third-party financial institution. In an agreement between Bank and Y, Y Affiliate guarantees the $500 loan. XY immediately purchases with the loan proceeds an asset of X's choice that is not a marketable security within the meaning of section 731(c). On the following day, XY distributes the newly purchased asset to X in liquidation of X's interest in XY. Y Affiliate continues to guarantee the $500 indebtedness to Bank.

(ii) Under paragraph (i)(8) of this section, X is treated as selling its interest in XY to Y Affiliate, and the transactional form of partnership borrowing and distribution is not respected for federal income tax purposes. The combination of XY's borrowing an amount equal to the capital account of X, the guarantee of that new bank loan by Y Affiliate that is disproportionate to Y Affiliate's capital interest in XY, and the short time frame over which the steps of the transaction occur evidence the fact it is appropriate to treat the transaction as a sale of X's interest in XY to Y Affiliate.

The revisions read as follows:

§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 seven years of each other), §1.707-5(a)(7)(ii) (regarding a liability incurred within two years prior to a transfer of property), §1.707-5(a)(8) (relating to liabilities assumed within seven years of the transfer), §1.707-6(c) (relating to transfers of property from a partnership to a partner in situations analogous to those listed above), and §1.707-7(j) (relating to certain transfers made within seven years of each other) is to be made in accordance with paragraphs (b) and (c) of this section.

* * * * *

(c) Parties required to disclose. The disclosure required by this section must be made by any person who makes a transfer that is required to be disclosed. The persons who are required to disclose may designate by written agreement a single person to make the disclosure. The designation of one person to make the disclosure does not relieve the other persons required to disclose from their obligation to make the disclosure if the designated person fails to make the disclosure in accordance with paragraph (b) of this section.

* * * * *

Par. 8. Section 1.707-9 is amended as follows:

1. Revising the heading for paragraph (a).

4. Revising paragraph (a)(3) by removing the language "1.707-6" and adding "1.707-7" in its place.

5. Revising paragraph (b).

The revisions and addition read as follows:

§1.707-9 Effective dates and transitional rules.

(a) Sections 1.707-3 through 1.707-7--(1) In general. Except as provided in paragraph (a)(3) of this section, §§1.707-3 through 1.707-7 apply to any transaction with respect to which all transfers that are part of a sale of an item of property or of a partnership interest occur on or after the date these regulations are published as final regulations in the **Federal Register**. For any transaction with respect to which all transfers that are part of a sale of an item of property occur after April 24, 1991, but before the date these regulations are published as final regulations in the **Federal Register**, §§1.707-3 through 1.707-6 as contained in 26 CFR edition revised April 1, 2004, (TD 8439) apply, except as provided in paragraph (a)(3) of this section.

(2) Transfers occurring before effective dates. * * * In addition, except as 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 after April 24, 1991, but before the date these regulations are published as final regulations in the **Federal Register**, the determination of whether the transaction is a disguised sale of a partnership interest under section 707(a)(2) is to be made on the same basis.

date these regulations are published as final regulations in the **Federal Register**. For transactions with respect to which all transfers that are part of a sale of property occur after September 30, 1992, but before the date these regulations are published as final regulations in the **Federal Register**, the disclosure provisions as described in §1.707-8 as contained in the 26 CFR edition revised April 1, 2004, (TD 8439) apply.

* * * * *

Acting Deputy Commissioner for Services and Enforcement

to change its accounting period for the taxpayer's first taxable year beginning after December 31, 1986—

"(A) such change shall be treated as initiated by the partnership, S corporation, or personal service corporation,

"(B) such change shall be treated as having been made with the consent of the Secretary, and

"(C) with respect to any partner or shareholder of an S corporation which is required to include the items from more than 1 taxable year of the partnership or S corporation in any 1 taxable year, income in excess of expenses of such partnership or corporation for the short taxable year required by such amendments shall be taken into account ratably in each of the first 4 taxable years beginning after December 31, 1986, unless such partner or shareholder elects to include all such income in the partner's or shareholder's taxable year with or within which the partnership's or S corporation's short taxable year ends.

Subparagraph (C) shall apply to a shareholder of an S corporation only if such corporation was an S corporation for a taxable year beginning in 1986

"(3) Basis, etc. rules.—

"(A) Basis rule.—The adjusted basis of any partner's interest in a partnership or shareholder's stock in an S corporation shall be determined as if all of the income to be taken into account ratably in the 4 taxable years referred to in paragraph (2)(C) were included in gross income for the 1st of such taxable years.

"(B) Treatment of dispositions.—If any interest in a partnership or stock in an S corporation is disposed of before the last taxable year in the spread period, all amounts which would be included in the gross income of the partner or shareholder for subsequent taxable years in the spread period under paragraph (2)(C) and attributable to the interest or stock disposed of shall be included in gross income for the taxable year in which the disposition occurs. For purposes of the preceding sentence, the term 'spread period' means the period consisting of the 4 taxable years referred to in paragraph (2)(C)."

Prior to amendment, para. (b)(1) read as follows

"(1) Partnership's taxable year. The taxable year of a partnership shall be determined as though the partnership were a taxpayer. A partnership may not change to, or adopt, a taxable year other than that of all its principal partners unless it establishes, to the satisfaction of the Secretary, a business purpose therefor."

—P.L. 99-514, Sec. 1805(a)(1)(A), substituted "such item" for "each such item" in clause (d)(2)(A)(i) . . . Sec. 1805(a)(1)(B), deleted "which are described in paragraph (1) and" following "of the following items" in subpara. (d)(2)(B) . . Sec. 1805(a)(2), substituted "the first day of the taxable year" for "the first day of such taxable year" in clause (d)(2)(C)(i), effective as provided in Secs. 72(c)(1) and (2) of P.L. 98-369, reproduced below

In 1984, P.L. 98-369, Sec. 72(a), added subsec. (d) . . Sec. 72(b)(1), deleted the last sentence in subpara. (c)(2)(A) . . Sec. 72(b)(2), deleted " but such partner's distributive share of items described in section 702(a) shall be determined by taking into account his varying interests in the partnership during the taxable year" after "or otherwise)" in subpara. (c)(2)(B), effective as provided in Secs. 72(c)(1) and (2), which read as follows

"(c) Effective date.—The amendments made by this section shall apply

"(1) in the case of items described in section 706(d)(2) of the Internal Revenue Code of 1954 (as added by Sec. 72(a), P.L. 98-369), to amounts attributable to periods after March 31, 1984, and

"(2) in the case of items described in section 706(d)(3) of such Code (as added by Sec. 72(a), P.L. 98-369), to amounts paid or accrued by the other partnership after March 31, 1984.

Prior to deletion, the last sentence in subpara. (c)(2)(A) read as follows:

"Such partner's distributive share of items described in section 702(a) for such year shall be determined, under regulations prescribed by the Secretary, for the period ending with such sale, exchange, or liquidation."

In 1976, P.L. 94-455, Sec. 213(c)(1), substituted "or with respect to a partner whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise)" for "or with respect to a partner whose interest is reduced" in subpara. (c)(2)(B), effective for partnership tax. yrs. begin. after 12/31/75.

—P.L. 94-455, Sec. 1906(b)(13)(A), substituted "Secretary" for "Secretary or his delegate" in paras. (b)(2) and (b)(2) and subsec. (c), for tax. yrs. begin. after 12/31/79.

(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership,

such allocation and distribution shall be treated as a transaction described in paragraph (1).

(B) Treatment of certain property transfers. If—

(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

(b) Certain sales or exchanges of property with respect to controlled partnerships.

(1) Losses disallowed. No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between—

(A) a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or

(B) two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

In the case of a subsequent sale or exchange by a transferee described in this paragraph, section 267(d) shall be applicable as if the loss were disallowed under section 267(a)(1). For purposes of section 267(a)(2), partnerships described in subparagraph (B) of this paragraph shall be treated as persons specified in section 267(b).

(2) Gains treated as ordinary income. In the case of a sale or exchange, directly or indirectly, of property, which in the hands of the transferee, is property other than a capital asset as defined in section 1221—

(A) between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership, or

(B) between two partnerships in which the same persons own, directly or indirectly, more than 50 percent

In 1988, P.L. 100-647, Sec. 1006(i), a
of P.L. 99-514, part of the transitional
P.L. 99-514, by substituting "Transitic
below.

In 1986, P.L. 99-514, Sec. 642(a)(2),
in subparas. (b)(2)(A) and (b)(2)(B), ef
end after 10/22/86. Sec. 642(c)(2) [as
see above] of this Act provides:

"(2) Transitional Rule for Binding
section [Sec. 642] shall not apply to sa
made pursuant to a binding contract in
thereafter."

—P.L. 99-514, Sec. 1805(b), substitute
of property" in clause (a)(2)(B)(ii), eff
P.L. 98-369, reproduced below

—P.L. 99-514, Sec. 1812(c)(3)(A), sub
paras. (b)(1)(A) and (b)(2)(A), effective

—P.L. 99-514, Sec. 1812(c)(3)(B), ad
tive as provided in Sec. 174(c) of P.L
Code Sec. 267

In 1984, P.L. 98-369, Sec. 73(a), ame
Secs. 73(b)(1)–(3) of this Act, which r

"(b) Effective date.—

"(1) In general.—The amendment m
369] shall apply—

"(A) in the case of arrangements des
nal Revenue Code of 1954 (as amended
or property transferred after February 2

"(B) in the case of transfers describe
so amended), to property transferred aft

"(2) Binding contract exception.—
shall not apply to a transfer of propert
such transfer is pursuant to a binding co
all times thereafter before the transfer.

"(3) Exception for certain transfers.—
shall not apply to a transfer of property
made before December 31, 1984, if—

"(A) such transfer was proposed in a
culated before February 28, 1984;

"(B) the out-of-pocket costs incurred
$250,000 as of February 28, 1984,

"(C) the encumbrances placed on suc
all constitute obligations for which neit
ble; and

"(D) the transferor of such property
ship."

Prior to amendment, subsec. (a) read as

"(a) Partner not acting in capacity as pa

"If a partner engages in a transaction
ity as a member of such partnership, t
provided in this section, be considered
one who is not a partner."

In 1976, P.L. 94-455, Sec. 213(b)(3), su
purposes of section 162(a)" for "and se
partnership tax. yrs. begin. after 12/31/7

—P.L. 94-455, Sec. 1901(b)(3)(C), subs
from the sale or exchange of property c
effective for tax. yrs. begin. after 12/31/

Sec. 708. Continuation of p

(a) General rule.