

The Leveraged Partnership—Have Your Cake And Eat It Too



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This is another in a continuing series of articles written by members of the ABA Tax Section in which a member of the section teams up with a member from the section's Young Lawyers Forum.

THE OWNER OF AN APPRECIATED BUSINESS

or investment asset is presented with an interesting dilemma when deciding whether to dispose of that asset. She is fortunate to own an asset worth more than its original cost; however, the Owner typically only obtains liquidity from that “locked in” gain by selling the asset, which triggers a tax liability. Therefore, the Owner may want to consider alternative options to obtain the benefit of the gain while deferring the tax. One option the Owner might consider is to enter into a section 1031 exchange. (All section references are to the Internal Revenue Code of 1986, as amended, (“Code”) and all Treasury Regulations promulgated thereunder.) In a section 1031 exchange, however, the Owner will receive another piece of property, rather than cash. Therefore, the Owner has achieved only one of her desired goals, tax deferral.

A second option the Owner may consider is a leveraged partnership transaction. In a leveraged partnership transaction, the Owner contributes the asset to a newly

formed partnership. The partnership then borrows money, while the Owner guarantees the partnership debt. The partnership then distributes the money to the Owner. If structured properly, the distribution to the Owner is tax free.

Although a leveraged partnership transaction can provide for a benefit as discussed in this article, the leveraged partnership transaction is not without risk and may be challenged by the IRS. Therefore, a taxpayer should obtain proper guidance before attempting such a transaction and should be aware that there is a likelihood, possibly a strong likelihood, of a challenge by the IRS.

EXAMPLE • To illustrate the above, assume Angie owns an asset with a fair market value of \$2,000 and a basis of \$100. If Angie sells the asset for its fair market value she will recognize a gain in the amount of \$1,900, albeit most probably capital gain. However, if Angie contributes the property to a partnership, or limited liability company (“LLC”) treated as a partnership for tax purposes, and enters into a leveraged partnership transaction, Angie may be able to access the \$1,900 gain, without triggering gain recognition. Angie can use the cash attributable to the gain for other expenses, or business ventures, while deferring the tax on the gain. When considering these numbers in the millions, the gain would likely be substantial, as would the resulting tax liability.

In addition, a leveraged partnership transaction may permit an S corporation with “built in” gain under section 1374 to dispose of the assets before the expiration of the 10-year recognition period without recognizing the built-in gain. This is because a leveraged partnership transaction does not involve a sale of assets. This was one of the reasons the parties in the Newsday transaction in 2008 structured the transaction as a leveraged partnership.

Newsday Transaction

In the Newsday transaction, the Tribune Company (“Tribune”) and Cablevision Systems Corporation (“Cablevision”) entered into a partnership where Tribune contributed assets related to the Newsday newspaper business. The assets contributed by Tribune were section 1374 assets and therefore Tribune would have recognized the built-in gain if the assets were sold. The partnership then borrowed money and distributed the money to Tribune. The debt was guaranteed by Cablevision, but Tribune agreed to indemnify Cablevision, intending that the ultimate risk would lie with Tribune, giving it a basis increase.

The Newsday transaction received a great deal of press and some criticism indicating that it will be challenged by the IRS. *See* Robert Willens, *Newsday Post Mortem*, 120 Tax Notes 1211 (Sept. 22, 2008).

Ultimate Benefits

Generally, if structured properly, a leveraged partnership may, under the right circumstances, provide the Owner with a deferral of the tax liability on the gain, while simultaneously providing potential liquidity from the asset. Thus, in a leveraged partnership transaction, if structured correctly, a taxpayer can possibly have her cake and eat it too. The following articles provide additional information on leveraged partnerships: Louis S. Freeman, Dean S. Shulman, Victor Hollender, *The Partnership Union: Opportunities for Joint Ventures and Divestitures*, Prac. Law Inst. (863 PLI/Tax 9) (2009) and Michael J. Kliegman and Jerome M. Schwartzman, *Puttin’ on the Blitz: The IRS Attacks a Leveraged Partnership Transaction*, 44 Tax Mgmt. Mem. 115 (2003).

STEPS • The general steps for a leveraged partnership transaction are as follows:

1. The Owner contributes appreciated assets and another partner, the Investor, contributes working capital (or assets) to a newly formed partnership. The Investor, in most circumstances, would eventu-

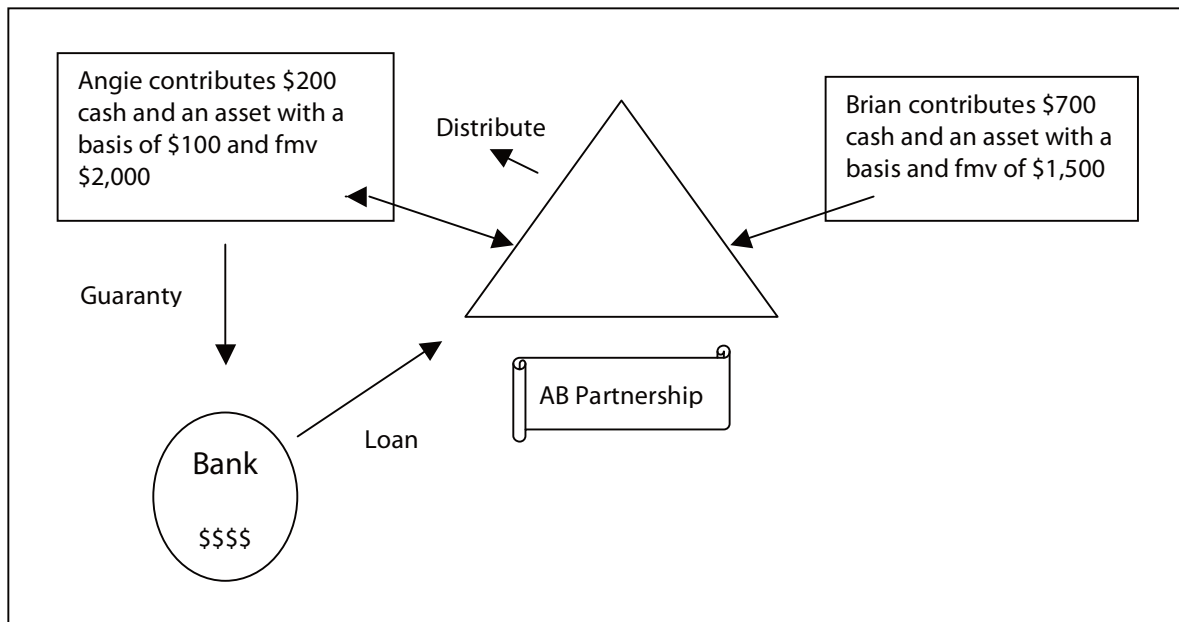
ally want to acquire those appreciated assets or use those assets in the operation of the partnership's business.

2. The partnership borrows money from a bank.
3. The Owner personally guarantees the debt of the partnership, making it a recourse debt as to her. As a result, the Owner's basis in her partnership interest is increased by the amount of the recourse debt.
4. The partnership distributes all or a portion of the loan proceeds to the Owner. The Owner's interest in the partnership is consequently reduced, making the Owner the minority partner of the partnership. Please note that the partnership agree-

ment should contain a mechanism to adjust the percentage interests to account for distributions and/or additional contributions.

5. Assuming that the transaction is properly structured to avoid application of the disguised sale rules, the distribution of all or a portion of the loan proceeds to the Owner should be tax free. If the Owner's basis was not increased by the debt, then the distribution would likely result in taxable gain to the Owner.
6. After seven years, the partnership can distribute the Owner's original assets to the Investor, or different partnership assets to the Owner.

The following diagram illustrates a leverage partnership transaction:



PARTNERSHIP BASICS • When parties join together to form a partnership, they should contribute assets to the partnership that would corroborate the partnership’s “business purpose” and support the parties’ intent. The parties’ intent is a key factor in determining if a partnership was formed. *Comm’r v. Culbertson*, 337 U.S. 733 (1949); *see also ASA Investments P’ship v. Comm’r*, 76 T.C.M. (CCH) 325 (1998), *aff’d*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000); *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir.2006). If the partnership is formed as a mere shell, then the IRS may disregard the partnership and treat it as a sham.

Generally, partners recognize no gain or loss on the contribution of assets to the partnership. Similarly, the partnership recognizes no gain or loss from the contribution of property by the partners. §721. The partners will have a basis in their partnership interest equal to the adjusted basis of the assets each contributed. §722. The partnership will have a transferred basis in the assets contributed. §723. A partner is also given basis credit for her allocable share of liabilities of the partnership. If her share of liabilities increases, she is treated as having contributed money to the partnership, and accordingly, her basis in the partnership interest is increased. §752(a); Treas. Reg. §1.752-1(b). If her share of liabilities is decreased, then the partner is treated as having received a cash distribution from the partnership and her basis is decreased by the amount of the deemed distribution. §752(b); Treas. Reg. §1.752-1(c).

There are special rules that are applied when a partner contributes property with a fair market value that differs from its basis. In this situation, there is a disparity between the property’s “book” value, or fair market value when contributed to the partnership, and the property’s tax basis. This property is called “built-in” gain property, or “704(c)” property (or “built-in loss” property, however, our discussion is focused on “built-in gain” property). The partnership rules require that “income, gain,

loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.” §704(c)(1)(A). The reason for this is to allocate any built-in gain to the partner who contributed the appreciated property to the partnership. The contributing partner could effectively shift the gain from the appreciated property if this was not done. These rules are designed to prevent a partner from shifting the gain to a partner in a lower tax bracket, or to a partner who may benefit from the gain (for example, by offsetting a loss).

There are several methods used to make this allocation, including the traditional method, the traditional method with curative allocations and the remedial allocation method. Generally, when nondepreciable property is contributed to a partnership, the contributing partner will be allocated the tax gain on the property when the partnership disposes of the property. In the case of depreciable property, depreciation deductions may be allocated more heavily to the noncontributing partner to allocate additional income and the corresponding built-in gain to the contributing partner. This is to take into account the difference between the tax and book accounts.

If the contributed property is distributed to a partner other than the contributing partner within seven years of being contributed, then the built-in gain is allocated to the contributing partner under section 704(c)(1)(A). §704(c)(1)(B). Gain (or loss) is recognized and there is a corresponding basis adjustment to the contributing partner’s interest in the partnership and to the property distributed to the noncontributing partner. §704(c)(1)(B); Treas. Reg. §1.704-4(e). If other property is distributed to the contributing partner within seven years of the contribution of 704(c) property, other than the property she contributed, then the contributing partner would also have to recognize gain under

section 737. There is also a corresponding basis adjustment for the partner's interest in the partnership and for the partnership in the contributed property. §§737(c)(1), 737(c)(2). When the partnership makes a distribution of cash or if there is a deemed distribution, i.e., a reduction in a partner's share of liabilities, there is no recognition of gain unless the distribution exceeds the partner's basis in the partnership interest. §731(a).

In a non-liquidating distribution of property, pursuant to section 732(a), the partner takes a transferred basis in the property from the partnership or the partner's basis in the partnership (reduced by cash distributed), whichever is less. In a liquidating distribution, the partner will take a basis in the property equal to her adjusted basis in the partnership interest (reduced by cash distributed). When the property is later sold, gain or loss will then be recognized. §732(b). If a partnership has a section 754 election in effect, then pursuant to section 734(b), the partnership will adjust the basis of its remaining assets by the amount of gain or loss recognized by a distributee partner. Treas. Reg. §1.734-1. If a partner sells her partnership interest, pursuant to section 741, then she will recognize gain or loss on the difference between the amount realized and the adjusted basis of her partnership interest. Treas. Reg. §1.741-1. The gain is capital, except to the extent of section 751 items, such as unrealized receivables or inventory.

ANALYSIS OF TRANSACTION • How then would such a leveraging transaction unfold?

Formation And Contribution Of Assets

The first step of a leveraged partnership transaction is to form a partnership or LLC. The partnership is formed with the other partner, in our example, Brian, who may ultimately want to obtain the appreciated asset Angie contributed to the partnership, (the "AB Partnership"). Angie contributes the appreciated property and Brian contributes

working capital or comparable assets supporting the business purpose of the partnership. As explained previously, subject to the disguised sale rules below, the contributions would be a nonrecognition event for the partners and the partnership.

The Loan/Distribution Of Cash

The next step in the transaction is for the AB Partnership to obtain a nonrecourse loan from a bank. The loan should be personally guaranteed by Angie. This guarantee serves several purposes, one of which is to give Angie basis credit in the amount of the guarantee, so that the distribution of loan proceeds to Angie will not be taxed. The second is to avoid immediate sale treatment on the transaction by qualifying for the exception to the disguised sale rules.

The partnership then distributes the loan proceeds to Angie. The distribution is tax free to the extent of Angie's basis. This distribution causes Angie's partnership interest in the partnership to decrease, making Angie a minority member and Brian the majority member. However, Angie must maintain a sufficient interest in the partnership to be recognized as a viable partner and to avoid any challenges by the IRS.

Ideally, the loan should be structured as an interest-only loan with a balloon payment which provides for the maximum tax deferral. If the partnership begins making principal payments on the debt, there is a deemed distribution to Angie, in the amount of the debt reduction.

The guarantee/distribution would cause Angie to increase the basis in her partnership interest by the amount of the loan guarantee and decrease the basis in her partnership interest by the amount of the distribution. The net effect of the guarantee and distribution is a wash, leaving Angie with the same original basis in the partnership interest, \$300. Angie now has the loan proceeds to use for other purposes, while deferring recognition of the tax liability from the appreciated asset.

After seven years, the partnership can distribute the assets that Angie contributed to the partnership to Brian or distribute other partnership assets to Angie without triggering section 704(c)(1)(B) or 737.

Although the above transaction seems fairly straightforward, there are a number of hurdles that a taxpayer must overcome including potential sale treatment under the disguised sale rules and anti-abuse characterization.

Disguised Sales Rules Generally

The disguised sale rules are the foundation from which the leveraged partnership transaction is structured. In general, the disguised sale rules prevent a partner from contributing property to a partnership, and then shortly thereafter, receiving a distribution from the partnership, which would be classified in substance as a sale. §707(a)(2)(B); Treas. Reg. §1.707-3. However, the current disguised sale rules also provide an opportunity, or an exception to the rule, which forms the basis of the leveraged partnership structure. Please note that the IRS and Treasury have from time to time commented on possibly making revisions to these rules. *See* the preamble to 69 Fed. Reg. 68838-01 (Nov. 26, 2004) (providing proposed regulations) and I.R.S. Announcement 2009-4 (Feb. 23, 2009) (announcing that the proposed regulations were subsequently withdrawn).

Determining A Disguised Sale

Many factors are considered in determining whether a transaction is a disguised sale. The Treasury Regulations will reclassify a transaction, such as a contribution followed by a cash distribution, as a sale, if based on facts and circumstances:

- (i) The transfer of money or other consideration would not have been made but for the transfer of property; and

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

Treas. Reg. §1.707-3(b)(1). The Treasury Regulations also provide a list of factors that may prove there was indeed a sale. The factors include:

- (1) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;
- (2) That the transferor has a legally enforceable right to the subsequent transfer;
- (3) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured.

Treas. Reg. §1.707-3(b)(2).

The Treasury Regulations create a presumption that if there is a transfer of property to a partnership and within two years after such transfer the partnership transfers property to that same partner, there is a sale, unless the facts indicate otherwise. There are also certain disclosure requirements related to the disguised sale rules. Treas. Reg. §§1.707-3(c)(2), 1.707-8. The order of the distribution and contribution do not matter, rather, the distribution to the partner can be paid before the contribution of property. Treas. Reg. §1.707-3(c). If there is a disguised sale, then the partner is treated as having sold the property and recognizes immediate gain. §707(a)(2)(B).

Liabilities

The disguised sale rules also apply if the partnership assumes or takes property subject to a liability. Treas. Reg. §1.707-5(a). The amount of the liability assumption is also treated as property transferred to the partner under the disguised sale rules.

The Leveraged Partnership Exception

If a partnership does not necessarily assume a liability, but accepts unencumbered property, shortly thereafter takes on debt in connection with that

same property, and subsequently transfers money obtained from that debt to the contributing partner, the transaction can be classified as a disguised sale. The leveraged partnership exception is built around this rule. Specifically, “if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under temp. Treas. Reg. §1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner’s allocable share of the partnership liability.” Treas. Reg. §1.707-5(b); *see also* Treas. Reg. §1.707-5(f) ex. 10 for an illustration of the rule. The success of the leveraged partnership transaction is structured around the concept of “allocable share” of liability.

Allocable Share Of Liability

A contributing partner’s “allocable share” of liability will determine if any of the loan proceeds distributed to her will be deemed a disguised sale. A partner’s “allocable share” of liability is determined under Treas. Reg. §1.707-5(b)(2) using the following formula:

(The partner’s share of liability × The amount of liability that is allocable under §1.163-8T to the money or other property transferred to the partner) / The total amount of liability

The partner’s share of liability is determined under Treas. Reg. §1.707-5(a)(2), which provides rules for determining a partner’s share of recourse and nonrecourse liabilities. A partner must be allocated enough of the liability to cover the distribution received. As is illustrated below, if a partner guarantees a partnership nonrecourse liability, and that liability is truly recourse to the partner, this results in all of that liability being allocable to that partner. In addition, parties have tried to allocate partnership nonrecourse liabilities based on a

partner’s share of “excess nonrecourse liabilities,” which will be discussed later. Finally, it may be possible to structure the transaction using a liability that is recourse to the partnership, but that discussion is beyond the scope of this article.

Recourse

For a partner who guarantees a partnership nonrecourse liability to be “allocated” that liability, it is important to ensure that the liability guaranteed by the partner is actually a recourse liability as to that partner. *See* Treas. Reg. §1.707-5(a)(2)(i). The Treasury Regulations define a recourse liability as one where “any partner or related person bears the economic risk of loss for that liability under §1.752-2.” Treas. Reg. §1.752-1. In this situation, the partner must be responsible if a liability becomes due and payable. Treas. Reg. §1.752-2(b). This determination is made using a “constructive liquidation test,” where there is a constructive liquidation and the partner obligated to make payment is the one who “bears the economic risk of loss.” Treas. Reg. §1.752-2(b)(1). The Treasury Regulations describe a constructive liquidation where the following events occur concurrently:

- (i) All of the partnership’s liabilities become payable in full;
- (ii) With the exception of property contributed to secure a partnership liability (see §1.752-2(h)(2)), all of the partnership’s assets, including cash, have a value of zero;
- (iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor’s right to repayment is limited solely to one or more assets of the partnership);
- (iv) All items of income, gain, loss, or deduction are allocated among the partners; and
- (v) The partnership liquidates.

Treas. Reg. §1.752-2(b). For the partner to bear the “economic risk of loss” the partner obligated to make good on the liability cannot be reimbursed by another partner. Treas. Reg. §1.752-2(b)(1).

Therefore, having Angie guarantee the debt, and ensuring that Angie bears the “economic risk of loss,” making the debt truly recourse as to her, would allow Angie to obtain adequate basis credit and would also prevent the transaction from being deemed a disguised sale. Angie bears the “economic risk of loss,” making the debt recourse as to her, if she is obligated to make payment if the partnership is “constructively liquidated” pursuant to the above criteria.

In addition, Angie should own other assets to strengthen the credibility of the recourse liability. If Angie takes on the liability from the partnership, but in actuality has no other assets, then the recourse liability may be disregarded or recharacterized by the IRS through its anti-abuse rules. Treas. Reg. §§1.752-2(b)(6); 1.752-2(j); CCA 200246014.

In other words, if the AB partnership incurs a nonrecourse liability in the amount of \$1,900 which Angie personally guarantees, and for which she bears the “economic risk of loss” making the liability truly recourse as to her, then Angie will receive basis credit in the amount of the liability. If the partnership, within 90 days of incurring that same liability, distributes \$1,900 to Angie, then the transaction will not result in disguised sale treatment because the distribution does not exceed Angie’s “allocable share of liability.” Angie will also not recognize gain on the transaction because Angie’s basis in her partnership interest will absorb the \$1,900 distribution and allow for a tax-free distribution. Please note, however, that if the amount distributed exceeds Angie’s basis in her partnership interest, Angie would recognize gain on the distribution.

In the following Chief Counsel Advisory, the facts of which are extremely complicated, the IRS disregarded a guarantee. In CCA 200246014, the Taxpayer announced that it wanted to sell certain assets. After considering several bids, Taxpayer entered into an agreement with X to sell off certain of its assets. Taxpayer then sold certain assets to X and contributed other assets to a joint venture

with X. A, a Taxpayer subsidiary, sold assets to D, a subsidiary of X, some of which D then contributed to the new LLC, Z. Among the assets sold was an interest in B. Taxpayer then transferred assets to a single member LLC, G, and then contributed its interest in G to Y, a wholly owned subsidiary. Taxpayer then received an interest in Z by contributing its interest in H, a single-member LLC. Taxpayer then contributed its membership interest in Z to Y. Subsequently, Y contributed its interest in G to Z. Y then had a certain percentage of common equity interest and preferred equity interest in Z.

Z then borrowed money from a syndicate of banks and made a special distribution to Y. Y distributed some or all of those funds to Taxpayer as a dividend. Y guaranteed Z’s debt and accordingly increased its basis. When Z borrowed the money, it entered into an agreement with the banks which provided that Z would only use the loan monies to finance the distribution to Y and that the special distribution would be distributed to Taxpayer. As part of the loan, Z pledged security interests in Z’s property which included a note from X. B and H, who were owned by Z, were also required to guarantee the loan and the lender could require payment from B and H without first going to Z.

Y also guaranteed the loan. The guarantee, however, only applied to the principal and was unsecured. It only applied after the banks exhausted any attempts to collect from Z. D, X, Y and Z also entered into a Tax Sharing agreement, where X and D agreed to indemnify Y for a loss of tax deferral on the special distribution, if caused by X or D.

The IRS disregarded the guarantee and treated the loan as a nonrecourse liability, indicating that the guaranty in that case should be disregarded because “Y’s relative lack of capital, the restrictive prerequisites for Y’s performance under the guarantee, and Z’s pledge of Note 2 from X all suggest a plan to avoid any performance obligation from Y on the guarantee.”

Accordingly, care must be taken to structure the guarantee to ensure that the underlying debt will be treated as a “recourse” liability to the partner.

Nonrecourse

A partner may also be “allocated” nonrecourse debt, without a guarantee; however, as discussed below, the IRS has challenged this type of structure. In general, if there is a nonrecourse liability, and there is no guarantee making the liability recourse to the distributee partner, then the disguised sale rules require that a partner’s “allocable share” of that liability be determined in the same method used for determining a partner’s share of excess nonrecourse liability under Treas. Reg. §1.752-3(a)(3). Treas. Reg. §1.707-5(a)(2)(ii). Generally, this is determined in accordance with a partner’s share of partnership profits. Treas. Reg. §1.752-3(a)(3). This determination is made by considering the facts and circumstances of the partners’ economic arrangement. The partnership agreement may allocate the interests in partnership profits to determine excess nonrecourse liabilities as long as the interests are “reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain.” Treas. Reg. §1.752-3(a)(3).

In the alternative, excess nonrecourse liabilities may be allocated in the manner the nonrecourse deductions relating to the liabilities may be expected to be reasonably allocated. Treas. Reg. §1.752-3(a)(3). A partnership may also allocate an excess nonrecourse liability first to a partner who contributed 704(c) property and is required to take into account the gain on that property to the extent that gain exceeds the gain under Treas. Reg. §1.752-3(a)(2). This is an important determination and the IRS has challenged taxpayers on different theories, including challenges as to what constitutes a “significant item of partnership income or gain.” *See* CCA 200513022; Tech. Adv. Mem. 200436011; CCA 200246014.

In Technical Advice Memorandum 200436011, the IRS determined if a “gross income allocation” would be considered a “significant item of partnership income or gain” for purposes of determining how much nonrecourse liability could be allocable to the Taxpayer, X, in a leveraged partnership transaction. In this transaction, X contributed assets to a limited liability company, Y. Y borrowed money and made a distribution to X and also issued to X a Senior Preferred Interest and a Junior Preferred Interest. X was “allocated 100% of the gross income every quarter up to the amount of the preference on the Senior Preferred Interest.”

The IRS challenged the Taxpayer’s claim that a Senior Preferred Interest was a “significant item of partnership income or gain.” The Taxpayer claimed that this resulted in 100 percent of the third-tier nonrecourse liabilities being allocated to the Taxpayer, thus preventing disguised sale treatment. The IRS argued that a “significant item of partnership income or gain” referred to a significant class of partnership income or gain. It argued that even though the Taxpayer is receiving 100 percent of a specific gross income allocation, the allocation did not correctly reflect the parties’ economic arrangement. *See also* CCA 200513022. Similarly, the IRS in CCA 200513022 (the facts are discussed below) challenged the taxpayer’s assertion that a “preferred return” was a “significant item of partnership income or gain” which would serve as the basis to allocate the nonrecourse liability to the taxpayer. The IRS stated that a “preferred return” did not reflect the economic arrangement among the partners.

The IRS in CCA 200246014, the facts of which were discussed above, after disregarding the guarantee, then stated that it was likely that the Taxpayer would claim that Y would still have a significant amount of the liability allocated to it, resulting in no gain. The IRS then found that Y was not allocated a sufficient amount of the nonrecourse liability to avoid disguised sale treatment.

Considering the challenges by the IRS, it is less risky to structure the transaction using nonrecourse debt with a guarantee that makes the debt recourse to the distributee partner.

Anti-Abuse

In addition to passing the disguised sale rules, the leveraged partnership must also make it through the anti-abuse rules, the sham characterization doctrine, and the substance over form doctrine.

Treasury Regulations

The general partnership anti-abuse rules under Treas. Reg. §1.701-2 require the following:

- (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.
- (2) The form of each partnership transaction must be respected under substance over form principles. . . .
- (3) [Transactions between the partnership and the partners must generally] accurately reflect the partners' economic agreement and clearly reflect the partner's income.

A transaction the principal purpose of which is to reduce a partner's tax liability in a way that is not consistent with the intent of Subchapter K may be recast by the IRS. This determination is made by conducting a facts and circumstances analysis. Treas. Reg. §1.701-2; CCA 200513022.

In CCA 200246014, the facts of which were discussed above, the IRS applied the anti-abuse rules and found that the transaction was entered into for the principal purpose of reducing the partner's federal tax liability. The IRS stated that "Taxpayer has monetized its equity in the approximately \$C worth of Assets while transferring the benefits and burdens of ownership of those Assets to D (and the X group)." The IRS also noted that the Taxpayer benefited from the deferral of gain and that the Taxpayer's direct sale to the Investor in the partnership of high basis/high value assets was a strong indicator that the Taxpayer entered

into the transaction with the purpose of reducing his federal tax liability.

In CCA 200513022, the IRS noted that the contributing taxpayer's initial intent was to sell the asset outright, and after considering tax savings, the taxpayer decided to enter into the transaction. The IRS noted that the Investor took into account the tax savings that the taxpayer would achieve as a result of the transaction and accordingly lowered its purchase price. The IRS also noted that when the asset, the building, was transferred to the Limited Liability Company, the taxpayer "no longer retained the benefits and burdens of ownership, and [taxpayer] no longer managed the building." The IRS concluded that the substance of the transaction was a sale, and that the transaction was entered into for the primary purpose of reducing the taxpayer's tax liability and the transaction was inconsistent with the intent of subchapter K. The IRS in CCA 200513022 also considered the anti-abuse rule under Treasury Regulation Section 1.704-4(f). This anti-abuse rule provides "[t]he rules of section 704(c)(1)(B) and this section must be applied in a manner consistent with the purpose of section 704(c)(1)(B). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B), the Commissioner can recast the transaction." The IRS noted the transaction was entered into to avoid the gain that would have been recognized if the building was sold.

Substance Over Form Doctrine

In addition, the leveraged partnership transaction must pass any substance over form challenges. The IRS in CCA 200246014 challenged the transaction based on the "substance over form" doctrine. The IRS in CCA 200246014 cited *Lyon v. United States*, 435 U.S. 561 (1978), in support of the "substance over form" analysis.

In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded the simple expedient of drawing up papers as controlling for tax purposes when the objective economic realities are to the contrary. In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding. Nor is the parties' desire to achieve a particular tax result necessarily relevant. [Citations omitted.]

CCA 200246014 (quoting *Lyon*, 435 U.S. at 573). The IRS concluded that the taxpayer in that case “effectively parted with the benefits and burdens” of the assets and yet received liquidity from the assets. Thus, the IRS argued that the transaction should be recast as in substance a sale and not as a contribution and distribution. CCA 200246014.

Sham Transaction Doctrine

The partnership must also not be a sham. The IRS in CCA 200246014 examined the facts to determine if the intent of the parties was to really form a partnership. CCA 200246014. The IRS cited *Comm'r v. Tower*, 327 U.S. 280 (1946), and *Comm'r v. Culbertson*, 337 U.S. 733 (1949), regarding the intent to form a partnership. The *Tower* case provided that “[w]hen the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both.” CCA 200246014 (quoting *Tower*, 327 U.S. at 286-87). The *Culbertson* case provided in response to the *Tower* case that:

The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes

for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

CCA 200246014 (quoting *Culbertson*, 337 U.S. at 742). See also *ASA Investorings P'ship v. Comm'r*, supra; *ACM P'ship v. Comm'r*, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); *TIFD III-E, Inc. v. United States*, supra. In CCA 200246014, the IRS determined that the partnership was not formed with an actual business purpose and determined that the partner who contributed highly appreciated property only had a nominal interest left in the partnership after a distribution, which was essentially a return of its capital contribution. The IRS also found that the same partner did not participate in the management of the partnership, did not perform services for the partnership, and found there was a tax avoidance motive. This led to the IRS concluding there was no valid partnership.

Therefore, the leveraged partnership transaction should be structured taking into account the various anti-abuse rules. Taxpayers should ensure the partnership has a business purpose and can pass any substance over form and sham transaction challenges. The anti-abuse rules discussed above are somewhat broad; thus, a taxpayer should be aware that the IRS may attempt to apply those rules to challenge a leveraged partnership transaction.

Operations Of Partnership And Exit Strategy

More than seven years after the formation of the partnership, the partnership can distribute other partnership property to the Owner and the Owner's original property can be distributed to the other partner. As a review, section 704(c)(1)(B) provides that if property is contributed to a partnership and within seven years that property is distributed to another partner, then the contributing partner will have to recognize the gain or loss under sec-

tion 704(c)(1)(A). *See also* CCA 200513022. Section 737 provides that if a contributing partner receives other property from the partnership within seven years, then the contributing partner has to recognize any remaining unrecognized pre-contribution gain. §737(a).

After seven years, the partnership can distribute the assets that Angie contributed to the partnership to Brian or distribute other partnership assets to Angie. Therefore, assuming no other income or loss, if Angie's basis in the AB partnership is \$300, and after seven years she receives a liquidating distribution from the partnership of property worth \$5,000, other than cash or marketable securities, then Angie's basis in this property received will be \$300, which is her basis in her partnership interest.

If the guaranty is deemed canceled by Angie's withdrawal from the partnership, then that would be a deemed cash distribution to Angie. Angie recognizes gain to the extent the amount of the deemed distribution exceeds her basis. If a section 734(b) election is in effect, then the partnership can increase the basis in its remaining assets by the gain recognized. These consequences likely occur in connection with the refinance of the original debt.

It is important to note that during the seven-year period, due to the section 704(c) allocation methods and any principal payments that may have been made by the partnership on the debt, some of the gain will be recognized. Thus, the structure allows for an amortization of the gain. Taxpayers should also be careful about distributions, whether actual or deemed, made during the two-year period, other than the loan proceeds, as that would trigger a "disguised sale" under the presumption.

A partner may sell her partnership interest instead of liquidating it, and in that case, the partner will recognize gain between the amount realized and her basis in the partnership interest. §741. The seller's amount realized includes a release from the guaranty. Treas. Reg. §1.752-1(h). Gain from a release of the guaranty would be recognized in this case as well.

CONCLUSION • The leveraged partnership transaction is sanctioned by the current Treasury Regulations, however, as indicated in the Chief Counsel Advisories, the IRS has, and may continue to challenge these transactions. Although the above Chief Counsel Advisories may only be internal advice given to IRS agents, they still illustrate the likely position of the IRS. For instance, as shown by the above Chief Counsel Advisories and Technical Advice Memorandum, it may be less risky to structure the transaction using a guarantee and consequently a recourse liability to the guarantor rather than allocating a nonrecourse liability. However, the guarantee/liability must be carefully drafted to ensure that it meets the criteria to be a true recourse liability. Taxpayers should take care in structuring the transaction, taking note of the potential IRS arguments as illustrated in this article. Although taxpayers must be wary of the various challenges that the IRS and courts may assert, if structured properly, a leveraged partnership can provide, in some instances, for the sought-after deferral of gain.

Checklist Of Steps For A Leveraged Partnership

- Form a partnership
- Contribute highly appreciated assets and capital
- Partnership obtains loan
- A guarantees the loan to make it a recourse loan
- Partnership distributes loan proceeds to A
- After seven years, A can exit the partnership and take other partnership assets, and B can receive the contributed property

Beware the Following:

- The disguised sale rules.
- Is the loan actually recourse?
- Adhere to the seven-year rule.
- Review the anti-abuse, sham transaction, and substance over form rules.

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