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Disguised Sales Between Partners and Partnerships: Section 707 and the Forthcoming Regulations

KAREN C. BURKE*

INTRODUCTION

In classifying transactions between a partner and a partnership for federal income tax purposes, it is important to determine whether the partner is acting in his capacity as a partner or as an unrelated party. In general, a bona fide sale or exchange of property between a partner and a partnership is treated as a transaction between unrelated parties under section 707(a)(1) of the Internal Revenue Code,1 subject to certain limitations.2 Classification of such transactions raises conceptual problems, however, because the relationship between the partner and the partnership is often ambiguous. Until recently, partners were often able to avoid sale or exchange treatment by structuring transactions as a tax-free section 721 contribution followed or preceded by a tax-free section 731 distribution from the partnership.

In the Tax Reform Act of 1984 (1984 Act), Congress adopted a statutory approach to the problem of "disguised sales" by enacting section 707(a)(2)(B).3 Congress was concerned that existing regulations and case law failed to prevent deferral or avoidance of tax on transactions which closely resembled

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1. I.R.C. § 707 (1986) (unless otherwise indicated, all Internal Revenue Code references are to the Internal Revenue Code of 1986 as currently amended). Section 707(a)(1) provides generally that "if a partner engages in a transaction other than in his capacity as a member of such partnership, the transaction shall . . . be considered as occurring between the partnership and one who is not a partner." Id. § 707(a)(1) (1986). See also id. § 707(a)(2)(A), (B) (1986) (added by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 73, 98 Stat. 494, 591 [hereinafter 1984 Act], and amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1805(b), 100 Stat. 2085, 2810 [hereinafter 1986 Act]).

2. Explicit statutory limitations on section 707(a) are set forth in section 707(b), as amended by the 1986 Act, § 642(a), 100 Stat. at 2283. Section 707(b)(1) disallows recognition of losses on sales between partners and controlled partnerships or between controlled partnerships, and section 707(b)(2) treats as ordinary income gain realized on certain sales between partners and controlled partnerships or between controlled partnerships. I.R.C. § 707(b) (1986).

3. Section 707(a)(2)(B) provides that transactions which are "properly characterized as a sale or exchange" will be treated as occurring between the partnership and a non-partner or between two or more partners acting in their capacity other than as partners. I.R.C. § 707(a)(2)(B) (1986). See also Treas. Reg. § 1.707-1(a) (1967); Treas. Reg. § 1.731-1(c)(3) (1987) (codified in I.R.C. § 707(a)(2)(B) (1986)).
sales of property or partnership interests.\textsuperscript{4} Under section 707(a)(2)(B), non-partner treatment may apply to a transaction in which property is transferred to a partnership and the transferor or another partner receives property or other consideration from the partnership contemporaneously with, or shortly after, the transfer.\textsuperscript{5} If section 707(a)(2)(B) applies, the transaction will be treated as a sale or as a part-sale, part-contribution.

Although Congress granted broad legislative authority to the Treasury to draft regulations implementing section 707(a)(2)(B), it is unclear whether this statutory provision will be any more effective than existing regulations in preventing disguised sales.\textsuperscript{6} Under section 707(a)(2)(B), a transaction must be properly characterized as a sale or exchange before non-partner treatment will apply. The legislative history offers little guidance, however, in distinguishing between a sale and a contribution-distribution. Even under the prior regulations, a transaction properly characterized as a sale was not entitled to nonrecognition treatment under sections 721 and 731. New section 707(a)(2)(B) codifies the existing regulations but does not purport to alter the general rules of Subchapter K concerning contributions and distributions.\textsuperscript{7}

This Article examines issues that will arise in drafting the section 707 regulations. Section I focuses on the potential for disguising sales or ex-

\textsuperscript{4} Staff of Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 225 (98th Cong., 2d Sess.) (Comm. Print 1984) [hereinafter Comm. Print]. See also Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980) (cash distributions made by satellite consortium reflecting payments made by new partners were tax-free distributions of the partnership and not proceeds of a sale of partnership interests); Otey v. Commissioner, 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (6th Cir. 1980) (contribution of property to partnership for which partner was guaranteed payment from subsequent loan to the partnership held not to be a taxable sale); Jupiter Corp. v. United States, 83-1 U.S. Tax Cas. (CCH) ¶ 9168 (Cl. Ct. 1983) (payment by new limited partners to existing partners not deemed a sale of partnership interests).

\textsuperscript{5} Section 707(a)(2)(B) applies if there is: (1) a direct or indirect transfer of money or other property by a partner to a partnership, (2) a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (3) the transfers, when viewed together, are properly characterized as a sale or exchange. I.R.C. § 707(a)(2)(B) (1986). A companion provision, section 707(a)(2)(A), is directed toward related abuses involving allocations and distributions as disguised payments for services or property. I.R.C. § 707(a)(2)(A) (1986).

\textsuperscript{6} Regulations under section 707(a)(2)(B) have not yet been issued. The ABA Section on Taxation, Committee on Partnerships, recently submitted extensive comments in question and answer form relating to section 707. Committee on Partnerships, Questions and Answers Relating to Section 707(a) of the Internal Revenue Code, A.B.A. Sec. Tax’n (Mar. 18, 1987) [hereinafter ABA § 707 Task Force]. For availability of these comments, see 35 Tax Notes 25 (Apr. 6, 1987). This Article draws significantly on the comments of the ABA Task Force, but reaches independent conclusions which differ in material respects from those of the ABA Task Force. For earlier commentary on the disguised sale problem, see N.Y. State Bar Ass’n Tax Section, Comm. on Partnerships, Comments Relating to Proposed Regulations To Be Issued Pursuant to Section 704(c), 707(a)(2) and 752 (1985) [hereinafter N.Y. Bar Comments]; ALI, Federal Income Tax Project: Subchapter K, Proposals on the Taxation of Partners 165-87 (1984) [hereinafter ALI Tax Project].

\textsuperscript{7} Comm. Print, supra note 4, at 231.
changes of property between partners and partnerships as nonrecognition transactions under prior regulations and case law. Section II examines the need for clarification of the scope of section 707(a)(2)(B) as an anti-abuse provision when property is transferred to a partnership and the contributing partner receives a related distribution. Section III addresses the related problem of disguised sales of partnership interests resulting from distributions in conjunction with the admission of new partners.

An underlying issue in all of these transactions is whether organizational transfers to a partnership should be analyzed under an entity or an aggregate partnership model. In general, Subchapter K adopts a predominantly aggregate approach to organizational transfers, but section 707 reflects a departure in the direction of an entity approach. Recently, two commentators have proposed replacing the existing nonrecognition provisions of section 721 with "immediate sale" treatment based on an entity approach to organizational transfers. Section IV of this Article concludes that "deferred sale" treatment is more consistent with the predominantly aggregate approach of Subchapter K, and would accomplish substantially the same results as immediate sale treatment while avoiding serious lock-in problems.

I. CHARACTERIZING DISGUISED SALES: CASE LAW AND REGULATIONS PRIOR TO THE 1984 ACT

A. Overview

The drafters of the regulations under the 1954 Code were aware of the possibility of combining contributions and distributions to achieve the economic equivalent of a sale. Section 1.731-1(c)(3) of the regulations provides that if within a short period before or after property is contributed to a partnership, other property is distributed to the contributing partner and the contributed property is retained by the partnership or another partner, section 731 may be inapplicable to the distribution. Section 1.721-1(a) of the regulations provides that "if the transfer of property by the partner to the partnership results in the receipt by a partner of money or other consideration . . . the transaction will be treated as a sale or exchange under section 707 rather than a contribution under section 721." According to section 1.707-1(a) of the regulations, "the substance of the transaction will govern rather

9. Treas. Reg. § 1.731-1(c)(3) (1987). The regulations provide further that if a distribution has the effect of an exchange of property between two or more partners, or between the partnership and a partner, it will be treated as an exchange.
than its form” in determining whether a partner is acting in a non-partner capacity. The regulations, however, fail to articulate criteria for distinguishing a disguised sale or exchange from a transaction governed by sections 721 and 731.

The regulations were intended to prevent transactions which constitute sales in substance, though cast in the form of contributions and distributions, from escaping sale treatment. Suppose that \( A \) contributes Blackacre, with a value of $200 and a basis of $100, and \( B \) contributes $100 cash to a partnership in return for equal partnership interests. \( A \) and \( B \) are credited with capital accounts of $200 and $100 respectively. In order to equalize the partner’s capital contributions, the partnership immediately distributes $100 cash to \( A \). If the transaction is governed by sections 721 and 731, \( A \) will treat the $100 distribution as tax free since it does not exceed his $100 basis in his partnership interest. The partnership will have a carryover basis of $100 in Blackacre.

If \( A \) is instead treated as selling a one-half interest in Blackacre to \( B \), \( A \) would recognize a gain of $50, the difference between the $100 cash received and \( A \)'s tax basis of $50 in one-half of Blackacre. Upon a contribution by \( A \) and \( B \) of a one-half interest in Blackacre, the partnership would have a stepped-up basis in one-half of Blackacre, reflecting the $50 of gain recognized by \( A \). Although these different methods of capitalizing the partnership are economically equivalent, \( A \) will defer reporting $50 of gain if the form of the transaction is respected. In either case, however, \( A \) has received $100 of cash for use outside the partnership.

The dichotomy between a sale and a contribution-distribution is further complicated by the tax treatment of borrowed funds. \( A \) could have borrowed $100 secured by Blackacre tax free and contributed the encumbered property to the partnership. When a partnership assumes or takes property subject to a liability of the contributor, the portion of the liability allocated to the other partners under section 752 is treated as a cash distribution from the partnership to the contributing partner. \( A \) would not recognize gain on a constructive distribution of $50, one-half of the liability, and \( A \)'s basis in his partnership interest would be reduced from $100 to $50. If the partnership uses the $100 cash contributed by \( B \) to pay off the liability, \( A \)'s remaining basis in his partnership interest ($50) would be reduced to zero. The result

12. Section 721(a) provides that “[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.” I.R.C. § 721(a) (1986). See also id. § 731 (1986) (recognition of gain or loss on a distribution).
is the same as if $A$ contributed the property free of liabilities to the partnership, and the partnership distributed $100$ cash to $A$.

Under the existing regulations, it is difficult to characterize the above transaction as a disguised sale, unless the constructive section 752 distribution is treated as an actual cash distribution. A constructive section 752 distribution occurs, however, whenever property is contributed to a partnership subject to liabilities. Disguised sale treatment seems inconsistent with the regulations under section 722 which treat a transfer of encumbered property as a tax-free section 721 contribution followed by a hypothetical cash distribution under section 752.\footnote{\textit{Treas. Reg.} § 1.722-1 (1987). \textit{See also} W. \textsc{McKee}, W. \textsc{Nelson} & R. \textsc{Whitmire}, \textit{Federal Taxation of Partnerships and Partners} \# 4.01[5] (1977) (Supp. 1987) [hereinafter \textsc{W. McKee}].} Under the regulations, the contributing partner recognizes gain on the deemed section 752 distribution only to the extent that the portion of liabilities of which the contributor is relieved exceeds the basis of the contributed property and the share of partnership liabilities allocated to the transferor.\footnote{\textit{Treas. Reg.} § 1.752-1(e), a general partner's share of partnership recourse liabilities corresponds to his interest in partnership losses, while his share of nonrecourse liabilities corresponds to his profit interest.}

A transfer of property to a partnership, subject to liabilities incurred in anticipation of the contribution, bears some resemblance to the problem addressed by section 357(b) in the corporate context. This provision treats as taxable "boot" the entire amount of liabilities assumed on a contribution of encumbered property to a corporation, if the contributing shareholder had a principal purpose of tax avoidance or lacked a bona fide business purpose. Section 357(b) is intended to prevent the transferor from bailing cash out of a corporation with earnings and profits by borrowing against the property just before the contribution, with the intention of keeping the borrowed funds and having the corporation pay off the liability. Under Subchapter K, however, cash distributions are normally tax free. Similarly, a transfer of encumbered property is permitted without gain recognition, even though a portion of the liability is effectively shifted to the other partners. Thus, it is necessary to distinguish between disguised sales and non-abusive transactions governed by the normal operating rules of Subchapter K.

\textbf{B. Transactions Cast as Contributions and Distributions}

Interpreting the Code and regulations prior to the 1984 Act, courts were generous to taxpayers seeking to avoid disguised sale treatment.\footnote{\textit{See also infra} notes 22-32 and accompanying text.} These cases

\footnote{\textit{See ALI Tax Project}, \textit{supra} note 6, at 178 n.17.}
"generally fail[ed] to specifically articulate the legal principles on which their decisions [were] based." The courts applied the step-transaction, sham-transaction, and business-purpose tests to determine whether a purported contribution and distribution should be treated as a taxable sale. The courts also considered whether the form of the transaction accurately reflected the parties' intent, and whether payment to the contributing partner was contingent upon partnership profits. The case law allowed partners considerable flexibility in structuring transactions to achieve the most desirable tax consequences, while warning that the choice of form was not unrestricted.

Section 707(a)(2)(B) was enacted partly in response to the decision in Otey v. Commissioner. In Otey, the taxpayer contributed land having a tax basis of $18,500 and a fair market value of $65,000 to a real estate development partnership, subject to an agreement that he would receive cash shortly thereafter from anticipated partnership borrowings. The taxpayer's partner, Thurman, contributed no capital but possessed the credit necessary to obtain financing. Twelve days after the contribution of the property, the partnership obtained a construction loan of $870,300, on which the partners were jointly and severally liable. Within a five-month period, Otey received a series of distributions approximately equal to the value of the contributed property.

The government argued that the transaction should be recast as a sale under section 707 and section 1.731-1(c)(3) of the regulations, rather than as a tax-free contribution and distribution. The court, however, concluded that the transaction was governed by sections 721 and 731, emphasizing that: (1) the partners treated the transaction as a contribution and the form was not artificial, (2) the land was essential to the partnership's business, (3) the land constituted the partnership's only contributed capital, (4) the taxpayer remained personally liable on the partnership's borrowing and might have been required to repay the loan if the venture were unsuccessful, (5) preferential distributions to equalize capital accounts are "usual and customary," and (6) the taxpayer could have achieved the same result by borrowing against the property as a sole proprietor. Finally, the court noted that the government's position would have been stronger had the cash distribution been derived directly from the other partner's contribution, rather than from partnership borrowing.

In Park Realty v. Commissioner, the court again upheld tax-free treatment for a partnership contribution promptly followed by a cash distribution.
In Park Realty, the partnership agreed to reimburse the taxpayer for certain pre-development expenses incurred in connection with contributed land, on which the partnership intended to develop a shopping center. The taxpayer received cash in excess of the actual pre-development costs from the proceeds of sale of a portion of the partnership's land. The land was to be used by several major department stores which planned to build their own facilities.

The government contended that the taxpayer had "sold" the pre-development expenses to the partnership, triggering taxable gain to the extent of the excess payment. However, the court held for the taxpayer primarily on the ground that the pre-development expenses did not represent assets which were transferable or valuable apart from the land. In addition, the court noted that the benefit to the partnership from the pre-development expenses undermined the government's argument that the taxpayer was acting in a non-partner capacity.

Thus, in both Otey and Park Realty, the court emphasized that the payments to the contributing partner were contingent or otherwise subject to the risk of the partnership business. This suggests that if a partner's profit from a transaction is assured, independent of the success or failure of the joint undertaking, the partner should then be treated as acting in a non-partner capacity under section 707. In Otey, the court concluded that the taxpayer's right to the payment was contingent because the distribution was derived from partnership borrowing and the taxpayer might have been called upon to repay the loan in the event that the partnership defaulted. However, the court failed to focus on whether the noncontributing partner, Thurman, would have been liable to his partner for a portion of the liability if the partnership lacked sufficient funds. To the extent that Otey could have proceeded against his partner for payment of one-half of the liability, he was assured of retaining a portion of the distribution.

By contrast, the court's holding in Park Realty seems sound. In Park Realty, the distribution was derived from a sale by the partnership of a portion of its assets rather than from borrowed funds or capital contributions of other partners. Since the distribution was contingent upon the partnership's operations, the other partners were not guaranteeing payment to the contributor. If a distribution depends on a substantial contingency to which a third party would be unlikely to agree without additional compensation for the risk involved, the contributing partner is not acting in a non-partner capacity. In Park Realty, however, it is unclear whether there was any

27. Id. at 419.
28. Id. at 419-21.
29. Id. at 422.
30. Otey, 70 T.C. at 320.
31. Park Realty, 77 T.C. at 416.
significant risk that the partnership would be unable to consummate the purchase agreement with the department stores.

*Park Realty* also involved the potential abuse of shifting the pre-contribution gain on the sale of the contributed property from the transferor to the other partners. The 1984 Act cured such abuses by amending section 704(c) to require that income, gain, loss and deductions with respect to contributed property be shared among the partners so as to take into account any difference between the basis of the property and its fair market value at the time of contribution. The special allocation rules of section 704(c) thus ensure that pre-contribution gain will ultimately be taxed to the contributing partner. The only difference is a matter of timing. If the initial transfer is treated as a contribution rather than a disguised sale, the contributor will defer the potential gain until the partnership sells or otherwise disposes of the contributed property.

In *Barenholtz v. Commissioner*, the taxpayer was unsuccessful in characterizing a sale as a contribution and distribution. The taxpayer initially structured the transaction as a sale of an undivided interest in property to three individuals, followed by a contribution of the undivided interests to a partnership comprised of the taxpayer and the other three individuals. The taxpayer subsequently sought to report the transaction as a contribution of his entire interest in the property, coupled with a cash contribution by the other partners, followed by a cash distribution equal to the amount contributed by the other partners. By recasting the transaction as a contribution and distribution, the taxpayer sought to offset his entire basis in the property, rather than only an allocable portion, against the amount of the distribution under sections 721 and 731.

The court rejected the taxpayer's attempt to avoid sale treatment through hindsight application of section 721. Despite the flexibility allowed partners in capitalizing a partnership, the court indicated that even had the trans-

34. *Id.* at 90-91.
35. The court stated:
   We think there were at least three methods, each with different tax consequences, whereby such a capitalization of the partnership might have been accomplished. First, petitioner could have sold [the property] to the partnership in a transaction within the purview of section 707(a). Second, petitioner could have contributed the property to the partnership pursuant to section 721 and the capital accounts of the partners could have been equalized by distributions within the purview of
action been cast in the form of a contribution and distribution, the form might not be respected.\textsuperscript{26} Barenholtz indicates merely that a taxpayer cannot escape the consequences of the form of the transaction by arguing that a "sale" was in substance a "contribution." Indeed, where the transaction is cast in the form of a contribution, the taxpayer must be prepared to demonstrate that appearances correspond to reality.

\textbf{C. Transactions Cast as Sales}

In some situations, it may be advantageous for a partner to structure a transfer to a partnership as a sale rather than a contribution. Thus, owners of appreciated land that is ripe for subdivision may seek to sell the land to a partnership in order to ensure that the inherent appreciation will be taxed as capital gain rather than ordinary income.\textsuperscript{3} Since the partnership will obtain a stepped-up basis, any ordinary income will be limited to the enhanced value attributable to the partnership's development activities. Alternatively, the sale format may be chosen in order to allow the transferor to recognize a loss. The sale device will not be successful, however, if the transferor owns more than 500/6 of the capital or profits interest in the partnership, since section 707(b), as amended by the Tax Reform Act of 1986, would deny recognition of any loss and require any gain to be taxed to the selling partner as ordinary income.\textsuperscript{38}

The elimination of preferential treatment of capital gains under the 1986 Act may lessen the attractiveness of the sale format, but a sale may still be advantageous if a taxpayer has capital losses that will fully absorb a capital gain. Particularly if the taxpayer can postpone recognition through installment reporting, a sale may still be desirable to provide the partnership with a stepped-up basis. The new passive loss rules may also enhance the attractiveness of a sale versus a contribution to a partnership.\textsuperscript{39} For example, assume that a taxpayer owns a large apartment building to which is allocable $500,000 of suspended passive losses. If the property is contributed to a partnership, the section 721 nonrecognition transfer will not trigger suspended
passive losses. Structuring the transfer as a fully taxable sale may trigger the suspended passive losses immediately, however, provided that the related party rules of section 707(b) are not applicable.

In two cases, the courts have considered whether transactions structured as sales should be treated in accordance with their form where the taxpayer sought the advantage of sale treatment. In *Davis v. Commissioner*, land was sold to a partnership which was formed to develop condominiums on the land. The taxpayer's controlled corporation and an unrelated party each held 50% interests in the partnership. Under the partnership agreement, the purchase price for the property was to be paid "with the first available funds and in all events whether the project was a success or failure." The court held that the transaction constituted a sale by the taxpayer acting in a non-partner capacity, relying chiefly upon the fact that the purchase price was payable "in all events." The court downplayed the fact that the taxpayer would have been liable to himself for one-half of the purchase price had the venture been unable to satisfy the obligation.

In *Oliver v. Commissioner*, the taxpayer transferred building lots to a partnership pursuant to an oral agreement that the partnership would purchase the lots for their appraised value. The taxpayer's capital account was originally credited with his cost for the property, but it was later increased to reflect the appraised value at the time of contribution. The purchase price was ultimately paid from the proceeds of the partnership's sale of the lots, and the partnership agreement did not provide for payment from any other source. The court held that the transfer was in substance a contribution rather than a sale, viewing the purchase agreement as signifying merely that the taxpayer would receive back his capital contribution first before any division of profits.

In *Davis*, the decisive factor was evidently that the payment to the contributing partner was guaranteed by the credit of the other partners to the extent of their percentage partnership interests. In *Oliver*, by contrast, the court viewed the payment as a distribution because the other partner was not guaranteeing payment in the event of a partnership default. In the case of a general partnership in which one partner contributes all of the capital and the other partner contributes only services, however, the distinction may

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40. S. REP. No. 313, 99th Cong., 2d Sess. at 727 (1986) (suspended passive activity losses triggered only "[w]hen the taxpayer disposes of his entire interest in the property received in the tax-free exchange").
41. I.R.C. § 469(g)(1)(A), (B) (1986).
42. 29 T.C.M. (CCH) 749 (1970).
43. *Id.* at 757.
44. *Id.*
45. *Id.*
46. 13 T.C.M. (CCH) 67 (1954), *aff'd per curiam*, 218 F.2d 352 (5th Cir. 1955).
47. *Id.* at 69-70.
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have no economic significance. Under partnership law, general partners may have an obligation to contribute the amount of any deficit capital account on liquidation of the partnership, unless the partnership agreement expressly provides otherwise.48

For example, assume A contributes land with a basis and fair market value of $100 and B contributes only services to general partnership AB. Although the capital accounts are unequal, A and B agree to share all profits and losses equally. All profits are distributed currently during the term of the partnership, so that pre-liquidation capital accounts remain $100 for A's benefit and zero for B. If the partnership property is then sold for only $80, resulting in an economic loss of $20 allocated equally to A and B, A will have a positive capital account of $90 and B will have a capital account deficit of $10. Unless the partnership agreement provides otherwise, B will be required to contribute to the partnership the amount of his deficit capital account balance for distribution to A. In effect, A bears the economic burden of one-half of the loss, or $10, and can proceed against B individually to collect the remaining $10.

A delayed payment obligation of the Davis type, which does not specify a fixed time of payment or bear interest, should probably not be viewed as sufficient to justify sale treatment. It might be argued that the parties should be permitted to choose sale treatment if they wish, since other provisions specifically address abuses in this area. The related party rules, however, apply only if more than 50% common ownership exists and merely circumscribe the benefits of sale treatment, even though a transaction is in substance a sale. Because sale treatment may still be advantageous in certain circumstances, the test should be an objective one based on the substance rather than the form of the transaction.

II. DISGUISED SALES AFTER THE 1984 ACT:
THE FORTHCOMING REGULATIONS

A. Disguised Payments for Property or Services

Congress was concerned that the existing regulations failed to address adequately the potential abuses of disguised sales. The 1984 Act amended section 707 to provide two new rules for determining when a partner is deemed to be engaging in a transaction with a partnership in a non-partner capacity. Section 707(a)(2)(A) is intended to prevent the use of related allocations and distributions as disguised payments for property or services.

48. See UNIF. PARTNERSHIP ACT § 18(a), 6 U.L.A. 1, 213 (1968) (unless otherwise agreed, partners "must contribute toward the losses, whether of capital or otherwise, sustained by the partnership" in proportion to their respective partnership interests in profits).
Section 707(a)(2)(B) deals directly with sales disguised as contributions and distributions.

Although sections 707(a)(2)(A) and 707(a)(2)(B) deal with related abuses, the tax consequences of recharacterizing transactions under these two provisions are quite different with respect to the contributing and noncontributing partners. If section 707(a)(2)(A) applies to a related allocation and distribution, the primary effect is to increase the share of partnership income allocable to the noncontributing partners. By contrast, the tax consequences to the contributing partner will generally be the same whether he is taxed on a purported allocation as a distributive share of partnership income or whether the accompanying distribution is recast under section 707(a)(2)(A) as a payment for property or services. The tax stakes are reversed, however, if section 707(a)(2)(B) applies to a related contribution and distribution, since the recharacterization will chiefly affect the contributing partner who would otherwise be treated as receiving a tax-free distribution.

1. Transfers of Property and Related Allocations: Section 707(a)(2)(A)

Section 707(a)(2)(A) nominally applies to transfers of property as well as services. It is aimed primarily, however, at the performance of services for a partnership by a partner acting as a third party. Congress was aware that partnership income could be deflected to a service provider by allocating to a purported partner performing services an amount of partnership income approximately equal to the fee that would otherwise have been paid to the service provider. By reducing the amount of income reportable by the other partners, the net effect of an allocation to the service provider for expenses of a capital nature is the same as a current deduction of a nondeductible expenditure. Section 707(a)(2)(A) combats this technique by providing that an allocation and distribution to a partner in connection with the performance of services or the transfer of property by a partner may be recharacterized as a transaction occurring between the partnership and a non-partner. In general, section 707(a)(2)(A) provides that allocations and distributions to partners will be treated as section 707(a)(1) payments for non-partner services if necessary to reflect properly their economic substance. Depending on the character of the services, the partnership must capitalize the payment to the non-partner where appropriate, thereby increasing the other partners' shares of taxable income.


50. Comm. Print, supra note 4, at 227-31 (listing six factors to determine whether a putative partner is receiving a distribution in a non-partner capacity).
Typically, section 707(a)(2)(A) will not apply to a property transfer because a related allocation and distribution disguised as a payment for property would cause the partnership to pay for the property twice. Under the section 704(b) rules for maintaining capital accounts, a contributing partner's capital account must be increased by the fair market value of contributed property. An allocation of additional income to the contributing partner as a disguised payment for property would result in a double capital account credit. This type of double counting for the contributed property would alter the economic arrangement among the partners, and is therefore unlikely to be accepted by the noncontributing partners. Accordingly, the legislative history indicates that related allocations and distributions in connection with property transfers will generally not trigger disguised sale treatment because the "requirement that capital accounts be respected under section 704(b) (and the proposed regulations thereunder) makes income allocations which are disguised payments for capital economically unfeasible and therefore unlikely to occur." 

For example, assume that a partner contributes appreciated property with a value of $200 and is to receive a preferential allocation and distribution from partnership gross income equal to a 20% return on his capital contribution for the first five years. During the first five years, the contributing partner will receive total allocations and distributions equal to $200. These allocations will be credited and the distributions will be debited to the contributing partner's capital account, leaving a positive balance of $200 which represents the fair market value of the contributed property. If the partnership is then liquidated, the regulations under section 704(b) require that the liquidating distributions be in accordance with the partners' positive capital account balances. Since the contributing partner would be entitled to a liquidating distribution of $200, the partnership would in effect have paid twice for the value of the contributed property. Relying on the economic tension between the partners to prevent such double counting, Congress believed that purported allocations and distributions would be unlikely to represent disguised property payments. 

Similarly, the legislative history provides that disguised sale treatment is generally inappropriate when a contributing partner receives a distribution and a related allocation of gain. For example, assume that a partner

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51. Treas. Reg. § 1.704-1(b)(2)(iv)(b) (1987). The fair market value assigned to contributed property will be considered correct, provided that the partners have sufficiently adverse interests and reasonably agree on such value. Id. § 1.704-1(b)(2)(iv)(h).
55. Id. at 231.
contributes property with a basis of $100 and a fair market value of $200. On a subsequent sale of the property by the partnership, section 704(c) requires that any excess of the fair market value of the property over its tax basis at the time of contribution be specially allocated to the contributing partner. A related distribution of the sales proceeds to the contributing partner is not abusive, since the contributing partner must recognize any gain deferred on contribution immediately when the partnership sells the property. Hence, the exception for an allocation of gain and a related distribution is generally proper, assuming that capital accounts are maintained in accordance with the section 704(b) regulations.

Congress nevertheless believed that there might be rare situations in which a purported allocation and distribution represented a disguised sale of property. Accordingly, the legislative history warns that disguised sale treatment may apply to a related allocation and distribution if: (1) valuation of the contributed property is below fair market value, (2) the property is sold by the partner to the partnership at a price below its fair market value, or (3) the capital accounts will be respected at such a distant point in the future that their present value is small and there is no meaningful return on capital accounts in the interval.56 Understatement of the value of contributed or purchased property, or the likelihood that capital accounts will not be satisfied until some distant date are circumstances which mitigate the double counting problem. If the present value of the contributing partner's capital account is small and the contributing partner enjoys no meaningful return on his capital account in the meantime, then the other partners might be willing to compensate the contributing partner through an increased allocation of additional income. Such an allocation and distribution, in the form of a disguised payment for property, might permit the partnership to avoid the requirement to capitalize the purchase price of property, without any economic detriment to the contributing partner.

For example, assume that a partner contributes property with a basis of zero and a fair market value of $100, and the contribution is reflected in the partnership's books and in the contributing partner's capital account at its zero basis. If the partnership allocates $100 of additional income to the contributing partner and makes a corresponding distribution, the contributing partner will be in the same economic position as if he had sold the contributed property for its fair market value. Because $100 of partnership income will be deflected to the contributing partner through the additional allocation, however, the distributive share of the noncontributing partners will be correspondingly reduced. In effect, the noncontributing partners will receive the economic equivalent of a current deduction for the purchase price of the property acquired from the contributing partner. In this unusual situa-

56. Id. at 229.
tion, section 707(a)(2)(A) will apply to recast the transaction as a disguised sale of the contributing partner's property to the partnership.

Such situations are likely to be rare, however, since the partnership's failure to credit the contributing partner's capital account with the fair market value of the contributed property will generally cause the partnership allocations to lack "economic effect" under the section 704(b) regulations; the failure to meet the detailed capital account requirements of section 704(b) will thus require reallocation of the partnership's income, gain, loss, and deductions in accordance with the partners' interests in the partnership. Although section 704(b) does not technically apply when a purported allocation is received by a partner other than in his capacity as a partner, it seems appropriate under section 704(b) principles to disregard the defective allocation and increase the partners' distributive shares of partnership income in proportion to their overall profit and loss sharing ratios. In addition, the contributing partner ought to be taxed as if he had received the preferential distribution as a disguised payment for the contributed property. Thus, the section 707 regulations should be coordinated with the economic effect test of the section 704(b) regulations.

The legislative history also indicates that the disguised sale provisions are not intended to affect distributions that create deficit capital accounts for which the distributee is liable. This safe harbor should apply, however, only to the extent that the obligation to restore deficit capital accounts has substantial economic effect within the meaning of the section 704(b) regulations. Since the distributee will be required to restore the deficit, the distribution is similar to a loan and should not be treated as a disguised payment for property (or a partnership interest). The safe harbor does not apply if the deficit capital account is "improperly understated or not expected to be made up until such a distant point in the future that its present value is small." A distribution which creates such a deficit capital account may be subject to section 707(a)(2)(A) if it is accompanied by an allocation of income or gain. Ordinarily, a contributing partner would be unwilling to accept such a deficit capital account liability, since he would not have received payment for the full fair market value of his property.

2. Transfers of Property and Related Distributions: Section 707(a)(2)(B)

Section 707(a)(2)(B) is the provision intended primarily to deal with disguised sales of property by a partner acting in a non-partner capacity. Section
707(a)(2)(B) applies if: (1) a partner transfers money or other property (directly or indirectly) to a partnership, (2) there is a related direct or indirect transfer of money or other property by the partnership to that partner (or another partner), and (3) when viewed together, the transfers are properly characterized as a sale of property.

A transaction described in section 707(a)(2)(B) is treated as a sale or exchange of property (including a partnership interest) occurring between the partnership and a non-partner or between two or more partners acting in a non-partner capacity. The selling partner will recognize gain or loss to the same extent as if all or a portion of the property were sold to a third party.63 The portion of the property sold should be determined by comparing the amount distributed with the fair market value of the contributed property. The relevant fair market value of the contributed property should generally be its fair market value as reflected in the partners' capital accounts as determined for purposes of section 704(c). The portion of a distribution in excess of the fair market value of the contributed property generally should not be treated as part of the sale proceeds, provided that capital accounts are respected.64

If the contributing partner is to receive a series of distributions, at least two possible approaches to the timing of gain are possible.65 Under the first approach, the sale would be treated as occurring at the time of the transfer. Related distributions would be treated as payments under a contingent installment obligation, and gain would be reported on the installment method as such payments are actually received. Under this approach, section 1274 or section 483 would recharacterize a portion of the distribution as interest if the installment obligation bears unstated or inadequate interest. The contributing partner would be required to recognize any recaptures or similar items in the year of transfer.66 A transfer of the contributing partner's partnership interest prior to receipt of all distributions would be treated as a disposition of an installment obligation, triggering deferred gain.67


64. For purposes of determining gain or loss, basis should presumably be allocated in proportion to the fair market value of that portion of the property which is deemed to be sold or contributed. See Rev. Rul. 78-357, 1978-2 C.B. 227 (suggesting that a contribution of property to a partnership in exchange for a partnership interest plus "boot" be treated as a taxable section 707(a)(1) transaction to the extent of "boot" received).

65. See N.Y. Bar Comments, supra note 6, at 48-49.


67. See ABA § 707 Task Force, supra note 6, at 59 (Q&A 71); id. at 58 (Q&A 70). See also N.Y. Bar Comments, supra note 6, at 52.
Under the second approach, the taxable event would be treated as occurring only when a related distribution occurs, without application of section 1274 or section 483. In effect, the transaction would be held open until the time of actual payment, when the amount received becomes ascertainable.\footnote{68} Although this second approach has the benefit of simplicity and administrative ease, it is difficult to reconcile it with the statutory language which seems to require that the "transfer" itself be treated as the sale event. Another drawback is that the second approach may be conceptually inconsistent with the idea of using fair market value at the time of contribution for purposes of determining the portion of the property deemed sold. Even if the regulations permit the second approach under some circumstances, it should not be available if the contributing partner receives in substance a non-contingent obligation to pay a fixed amount at a definite time.\footnote{69} In this event, the transfer itself should be viewed as the sale event, subject to the rules of section 1274 and section 483. Under either approach, any adjustments to the partnership's basis should occur only when, and to the extent that, the contributing partner recognizes gain.

B. Partnership Borrowing and Transfers of Encumbered Property

A partner contributing property to a partnership may extract cash in two ways: by borrowing against the property and then contributing the encumbered property to the partnership or by contributing the property and then causing the partnership to borrow against it and distribute the proceeds of the borrowing to the contributing partner. Regardless of how the transaction is structured, the economic effect may resemble a sale if the contributing partner receives cash from borrowed proceeds and directly or indirectly shifts the economic burden of repaying the debt to the partnership or the other partners. In enacting the disguised sale provisions, Congress intended that the section 752 rules for sharing partnership liabilities would govern in determining whether a contributing partner has retained substantive liability for borrowed funds. Because the section 752 sharing rules were developed in a different context and may themselves fail to reflect economic reality, however, application of these rules to the disguised sale provisions is fraught with difficulties.

The legislative history provides that disguised sale treatment may apply when:

(1) the transferor partner receives the proceeds of a loan related to the property and responsibility for repayment of the loan rests, directly or indirectly, with the partnership (or its assets) or the other partners, or

\footnotesize\begin{itemize}
  \item \footnote{68} See N.Y. Bar Comments, \textit{supra} note 6, at 49.
  \item \footnote{69} Id.
\end{itemize}
(2) the partner has received a loan related to the property in anticipation of the transaction and responsibility for repayment of the loan is transferred, directly or indirectly, to the partnership (or its assets) or the other partners.  

According to the legislative history, no change is intended in the "general rules concerning the tax treatment of partners under sections 721, 731 and 752" upon a contribution of property encumbered by liabilities not incurred in anticipation of the contribution.  

Nor is a change intended upon a contribution resulting in a shift in existing partnership liabilities not incurred in anticipation of the contribution.

The Joint Committee Report contains additional language clarifying the treatment of liabilities where a partner contributes property to a partnership and that property is then borrowed against, pledged as collateral for a loan, or otherwise refinanced. If the proceeds of the loan are distributed to the contributing partner:

there is not a disguised sale to the extent the distributed proceeds are attributable to indebtedness properly allocable to the contributing partner under the rules of section 752 (i.e., to the extent that the contributing partner is considered to retain substantive liability for repayment of the borrowed amounts), since, in effect, the partner in this case has simply borrowed through the partnership.

The Joint Committee Report adds, however, that disguised sale treatment may apply "to the extent the other partners directly or indirectly (as through the exposure of their share of partnership asset [sic]) bear the risk of loss with respect to the borrowed amounts." The rule that the other partners and the partnership assets must bear no direct or indirect risk of loss is more far-reaching than the present section 752 rules concerning the assumption of liabilities. In the 1984 Act, Congress also directed the Treasury to revise the existing section 752 rules for sharing partnership liabilities to ensure that liabilities be allocated, to the extent possible, to those partners bearing "the economic risk of loss with respect to such liabilities." The revised section 752 regulations are expected to address the rules for sharing both recourse and nonrecourse liabilities.

Under the existing section 752 regulations, recourse liabilities are allocated among general partners in accordance with their ratios for sharing losses, thereby reflecting the manner in which such liabilities would be funded in

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70. Comm. Print, supra note 4, at 232.
71. Id. at 231.
72. Id.
73. Id. at 232.
74. Id.
the event of a partnership default.\textsuperscript{77} Since a recourse creditor may proceed against the obligor's personal assets, general partners theoretically are personally liable for repayment of recourse debt if the partnership has insufficient assets. The allocation of recourse liabilities based on the contingency of partnership default may be unrealistic because "most loans, whether recourse or nonrecourse, are based primarily on the value of the property used to secure the loan, and in the event of default, the lender typically looks first to the property rather than any persons who may be personally liable."\textsuperscript{78} Moreover, the section 752 sharing rules overlook the likelihood that recourse debt may be retired from partnership profits or assets.\textsuperscript{79} Thus, the language in the 1984 Act concerning "economic risk of loss" may be interpreted as requiring modification of the rules allocating recourse debt in accordance with the partners' loss ratios.\textsuperscript{80} Although the revised section 752 regulations may provide additional clarity and refinement, it seems unlikely that they will abandon the personal liability theory for sharing recourse liabilities.\textsuperscript{81}

1. Reversing Otey-Type Transactions

Congress evidently intended that section 707(a)(2)(B) would reverse the result in Otey, cited with disapproval in the legislative history.\textsuperscript{82} Despite Congress' intent to treat an Otey-type transaction as a sale, however, section 707(a)(2)(B) does not clearly reach this result. Under the specific facts in Otey, the distribution from partnership borrowing was less than the contributing partner's allocable share of the partnership's recourse liabilities which substantially exceeded the fair market value of the contributed property. Since the entire distribution could conceivably be viewed as allocable only to Otey's share of partnership liabilities under section 752, taxpayers might reasonably conclude that section 707(a)(2)(B) does not require sale treatment on identical facts. Nevertheless, given Congress' express disapproval of the result in Otey, section 707(a)(2)(B) should be interpreted in a manner consistent with the legislative intent. To avoid any uncertainty, the regulations should specifically state that the new statute is intended to reverse the Otey result.

\textsuperscript{77} Treas. Reg. § 1.752-1(e) (1987).
\textsuperscript{78} W. McKee, supra note 16, ¶ 8.01[1] n.6.
\textsuperscript{79} Id.
\textsuperscript{81} See Postlewaite & Bialosky, supra note 80, at 791-92.
\textsuperscript{82} See Comm. Print, supra note 4, at 225; supra notes 22-25, 30 and accompanying text.
Even if *Otey* is reversed for transactions occurring after enactment of section 707(a)(2)(B), however, it is uncertain whether a contributing partner in an *Otey*-type transaction will be treated as selling all or only a portion of the contributed property. In *Otey*, the government argued unsuccessfully that the transaction should be treated as a sale of the entire property to the partnership, rather than a sale of only a portion of the property. Partial sale treatment seems more appropriate under these circumstances, however. According to the Joint Committee Report, a distribution of borrowed funds will not result in disguised sale treatment to the extent that the distributee retains substantive liability for repayment of the debt. Since the taxpayer in *Otey* was personally liable for half of the partnership borrowing if partnership funds were insufficient, section 707(a)(2)(B) should treat a similar transaction as a sale of only a one-half interest in the property.

This treatment would reflect the sharing of the economic burden of repaying the underlying liabilities according to section 752, if such liabilities were taken into account only to the extent of the fair market value of the contributed property. Under section 752(c), a liability to which property is subject is considered a liability of the owner only to the extent of the fair market value of the property. Therefore, in cases such as *Otey* where the liabilities exceed the fair market value of contributed property, part-sale treatment is consistent with the limitation on liabilities under section 752(c). A fair-market-value limitation on the amount of liabilities taken into account is also necessary to ensure consistent treatment regardless of whether the property is borrowed against before or after the contribution to a partnership.

In *Otey*-type transactions, it will often be difficult to determine whether the distribution is derived from partnership borrowings or the capital contributions of other partners. The distinction is important, however, because the tax consequences to the contributing partner may be quite different depending on the source of the distribution. On the one hand, only a portion of the distribution, determined under section 752, will be treated as disguised sale proceeds if the source of the distribution is considered to be partnership borrowing. On the other hand, the entire distribution will be treated as disguised sale proceeds if the source of the distribution is considered to be capital contributions of other partners. The source of the distribution generally will not have any significant effect on the noncontributing partners, however. Although the source of the distribution might be determined under a facts-and-circumstances test, such a test would be administratively difficult to apply. Therefore, the regulations may adopt a presumption that distributions are traceable first to capital contributions of other partners.

83. See *supra* note 73 and accompanying text.
84. See N.Y. Bar Comments, *supra* note 6, at 47.
85. *Id.* at 48-49.
rather than partnership borrowing, absent clear and convincing evidence to the contrary.86

For example, assume that $A$ contributes property worth $200, with a tax basis of $100, and $B$ contributes $100 cash to a partnership. If the partnership immediately distributes $100 to $A$, $A$ should be treated as having sold one-half of the contributed property. The result should be the same if $B$ contributes $100 cash and the partnership also borrows $200. A distribution of $100 of borrowed funds to $A$ should be treated as a sale of one-half of $A$'s property, even though the distribution does not exceed $A$'s share of liabilities under section 752. Under the presumptive tracing rule, the $100 distribution should be traced to $B$'s capital contribution, unless the partnership overcomes the presumption.

2. Nonrecourse Liabilities

The legislative history seems to indicate that no disguised sale results if contributed property is transferred subject to nonrecourse liabilities because the economic burden of repayment will not be shifted to any of the other partners or partnership assets.87 Under the section 752 sharing rules, nonrecourse liabilities are allocated among the partners in accordance with their share of partnership profits.88 Since none of the partners bears any personal liability for repayment of the debt, allocation of nonrecourse liabilities in accordance with profit ratios reflects the assumption that such debt will be repaid only if the partnership has sufficient profits. If contributed property is transferred subject to nonrecourse liabilities and the partnership specially allocates the gain from the contributed property to the contributing partner under section 704(c) principles, the special allocation may be sufficient to prevent any portion of the liabilities from being allocated to the other partners.89 Since the contributing partner is specially allocated the profits that will be used to retire the liability, arguably the nonrecourse liabilities should be assigned only to the contributing partner.

If the contributed property is subsequently disposed of by sale, abandonment, or otherwise, the amount realized on the disposition will include the nonrecourse liabilities under Commissioner v. Tufts.90 In Tufts, the fair-market-value limitation of section 752(c) was confined to contributions and distributions of partnership property, as opposed to sales or exchanges.91

86. Cf. id. at 49 (determination of the source of distributions should be based on a facts-and-circumstances test). See also infra notes 132-34 and accompanying text.
89. W. McKee, supra note 6, ¶ 4.03.
Section 7701(g), added by the 1984 Act, codifies Tufts by providing that the fair market value of property on a disposition shall be treated as not less than the amount of liabilities to which the property is subject. In accordance with section 704(c) principles, the contributing partner would apparently be required to recognize any pre-contribution gain to the extent of the nonrecourse liabilities on disposition of the property. Although the deferral of the contributor's gain may be significant because of the time value of money, a taxpayer may normally receive nonrecourse borrowing tax free even though the liabilities exceed the basis of the property.\(^9\)

Given the broad authority that Congress granted to the Treasury in this area, the regulations may nevertheless conclude that consistent treatment of recourse and nonrecourse borrowing is necessary to prevent avoidance of the disguised sale rules.\(^9\) This approach would not seem to be precluded by the contrary implication in the legislative history that a disguised sale does not result if nonrecourse borrowing is secured by the contributed property.\(^4\) Frequently, other partnership assets, including equity in the contributed property, will be available to service principal and interest on the nonrecourse debt.\(^9\) The regulations, therefore, may interpret broadly the language in the legislative history that the other partners must not bear the risk of loss associated with the partnership borrowing, directly or indirectly, through their share of partnership assets.\(^9\) The revised section 752 regulations, however, should clarify how nonrecourse liabilities are allocated among the partners when a contributing partner receives a special allocation of gain with respect to contributed property transferred to the partnership subject to nonrecourse liabilities.\(^9\)

### 3. Nonabusive Transactions

A contribution of property subject to recourse or nonrecourse liabilities should not result in disguised sale treatment, however, merely because of a constructive section 752 distribution provided that the liability was not incurred in anticipation of the contribution.\(^9\) If the prospective partner has not “cashed out” his investment through borrowing in expectation of a contribution, the prerequisite for deemed sale treatment is absent. Therefore,

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92. See Woodsam Assocs. v. Commissioner, 198 F.2d 357 (2d Cir. 1952), aff'd 16 T.C. 649 (1951) (nonrecourse borrowing not a taxable event even though loan proceeds exceed taxpayer's basis in the property).

93. See ABA § 707 Task Force, supra note 6, at 52 (Q&A 59).

94. See supra note 87 and accompanying text.

95. See supra note 74-75 and accompanying text.

96. See supra notes 74-75 and accompanying text.

97. The section 707 regulations should be coordinated with the revision of the section 752 regulations to address this issue.

98. See supra note 71 and accompanying text.
the rule that a transfer of property subject to preexisting debt generally does not give rise to disguised sale treatment is consistent with the congressional intent not to alter the general rules concerning the tax treatment of partners under sections 721, 731, and 752.

The disguised sale rules seem sufficiently broad to encompass transactions in which a partner borrows funds to acquire, improve or refinance property in anticipation of a contribution of the encumbered property to a partnership.99 The legislative history indicates, however, that Congress intended the regulations to take into account Congress' "concern with transactions that attempt to disguise a sale of property and not with non-abusive transactions . . . ."100 Disguised sale treatment does not seem appropriate when borrowed funds are used to acquire, improve, or refinance property, since the contributing partner has not extracted cash from the property for his personal use. From the Treasury's perspective, it should make no difference whether funds are borrowed in connection with acquisition and improvement of property before or after formation of the partnership.101 Accordingly, the regulations should provide that disguised sale treatment does not result to the extent that pre-contribution borrowing is used exclusively to: (1) finance the acquisition or improvement of the contributed property, (2) refinance a loan encumbering the property which was not incurred in anticipation of the contribution, or (3) pay costs and expenses directly related to such refinancing.102

A partner may contribute property subject to recourse liabilities, remaining primarily liable for the indebtedness on the contributed property. Even if the debt is incurred in anticipation of the contribution, disguised sale treatment should not result since the contributing partner has retained substantive liability for repayment of the borrowed funds. The section 752 regulations do not provide specific guidance concerning the allocation of liabilities where a partner remains primarily liable on encumbered property transferred to a partnership. Consistent with the economic-risk-of-loss standard mandated by Congress, the revised section 752 regulations should allocate the entire liability in this situation to the partner who will ultimately be forced to repay the indebtedness. If the contributing partner retains primary liability with respect to only a portion of the indebtedness, the debt should presumably be bifurcated for purposes of the disguised sale rules.103

99. The Joint Committee Report indicates that disguised sale treatment may be appropriate when a partner would have been forced to repay the liability within a short time had the liability not been assumed and paid by the partnership, even though the liability is not incurred in anticipation of a contribution. Comm. Print, supra note 4, at 231 n.10.
100. Id. at 231.
101. W. McKee, supra note 16, ¶ 13.02[5][b].
102. See ABA § 707 Task Force, supra note 6, at 53-54 (Q&A 62).
103. See Rev. Rul. 84-118, 1984-2 C.B. 120 (bifurcating partnership liability into recourse and nonrecourse portions); Postlewaite & Bialosky, supra note 80, at 774-76.
C. Step-Transaction Issues

Disguised sale treatment will result only if a series of transfers, when viewed together, are "properly characterized as a sale of . . . property." The legislative history states that the Treasury may issue regulations that "provide for a period, such as three years, during which contributions by and distributions to the same or another partner will normally be presumed to be related for purposes of the disguised sale rule." Thus, transfers occurring within the specified period would be collapsed into a single transaction, resulting in retroactive sale treatment under section 707(a)(2)(B) unless the taxpayer overcame the presumption that the transfers were prearranged. If a distribution occurs more than three years before or after a contribution, the regulations may establish a presumption that the transfers are unrelated. Consistent with the latitude granted by Congress, the regulations should establish presumptive rules, rather than leaving application of the statute to be governed solely by subjective intent. The presumption might be rebuttable with a showing of clear and convincing evidence, or some other standard, that a distribution was not anticipated at the time of the contribution. A three-year rule should generally be sufficient to safeguard against abuses. The regulations should make clear, however, that the statute can be applied to clearly abusive transactions that are designed to fall outside the three-year rule.

For example, a mere delay in the timing of a distribution should not be sufficient to preclude disguised sale treatment if the contributing partner is reasonably certain to receive a distribution. Otherwise, the partnership could simply invest retained cash in relatively risk-free assets, such as bonds or certificates of deposit, for subsequent distribution. The installment sale provisions provide that receipt of evidence of indebtedness will be treated as an actual payment if "secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note." Therefore, if a partnership holds such assets for the purpose of distributing them to a contributing partner, and the assets are not pledged to secure other obligations of the partnership, a distribution occurring outside the three-year period should be recharacterized as a disguised payment for property. Applying this same reasoning, an obligation of the partnership fixed in amount and time of payment should also trigger deemed sale treatment, regardless of whether the payment schedule extends beyond the three-year period.

106. See N.Y. Bar Comments, supra note 6, at 32.
108. See ABA § 707 Task Force, supra note 6, at 48-49 (Q&A 52).
Similar step-transaction issues may arise in determining whether there is a prearranged plan to combine borrowing with a partnership contribution. It seems unrealistic to treat any borrowing incurred within three years of a contribution as presumptively related to the contribution. A six-month rule is more likely to reflect business realities in testing whether the borrowing and contribution are related. If the borrowing occurs more than six months before the contribution, there should be no presumption of prearrangement. A borrowing which occurs less than six months prior to a contribution may be presumed to be related, unless the taxpayer can demonstrate the absence of prearrangement.

Disguised sale treatment should apply only if the contributing partner receives, or is "reasonably certain" to receive, a distribution related to the contribution. The regulations should provide examples illustrating when a distribution will be considered to be reasonably certain based on facts and circumstances. The examples should focus on the source of the payment, the degree of risk involved, and other relevant factors. Particularly, the regulations should address whether a distribution which is derived from operating cash flow earned after the contribution can be considered a disguised payment for property. Under a facts and circumstances test, the regulations might focus on the likelihood at the time of contribution, given the nature of the partnership's business, of whether sufficient cash flow would be available to make the distribution. Alternatively, the regulations might adopt a presumption that a preferential distribution from subsequent operating cash flow is not reasonably certain, regardless of the likelihood of sufficient cash flow.

A preferential distribution that can be derived only from partnership cash flow from operations—as opposed to partnership borrowings, contributions, or sales of contributed property—should normally be viewed as subject to material entrepreneurial risk. Because the contributing partner would not be assured of receiving the preferential distribution in a non-partner capacity, disguised sale treatment seems inappropriate. Even if the partnership agreement does not specifically restrict the source of a preferential distribution, disguised sale treatment should arguably not apply if the preferential distribution is in fact dependent on net cash flow from operations. In this situation, to avoid disguised sale treatment, the distributee partner should be required to demonstrate that the distribution would not have been made had the partnership not generated sufficient cash flow. Thus, a preferential distribution actually derived from net cash flow might nevertheless be viewed

110. See ABA § 707 Task Force, supra note 6, at 49-50 (Q&A 54).
111. See ALI TAX PROJECT, supra note 6, at 187.
112. See N.Y. Bar Comments, supra note 6, at 35.
113. See ALI TAX PROJECT, supra note 6, at 187.
114. See N.Y. Bar Comments, supra note 6, at 35-36.
as disguised sale proceeds if circumstances indicate that the partnership would have satisfied the preference from borrowings or other sources in the absence of sufficient net cash flow.

If a distribution is derived from a source other than partnership net cash flow from operations, the regulations should focus on whether the distribution is subject to a contingency within the control of the partners. For example, a partnership may borrow funds for construction which is to be completed for a fixed price within three years after a contribution of property. If the partnership agreement provides that excess borrowed funds are to be distributed to the contributing partner when the construction is completed, and the amount of the borrowing exceeds the fixed cost of the construction, the distribution should be treated as a disguised payment for property.\textsuperscript{115} If the construction cost is not fixed and the distribution will occur only to the extent that the partnership has excess borrowed funds upon completion of the construction, there may be a substantial risk that the partnership will have insufficient funds to make the distribution. Because the cost of the construction is a contingency outside the control of the partners, a subsequent distribution from excess borrowed funds should not trigger deemed sale treatment.\textsuperscript{116}

III. Sale or Liquidation of a Partnership Interest: Taxing Distributions and Dispositions

A. Prior Case Law and Regulations

Section 707(a)(2)(B) is intended to ensure that certain transactions are treated as sales of partnership interests rather than tax-free distributions under section 731. A sale of a partnership interest and a distribution in liquidation of a partner’s interest may have substantially different tax consequences. For example, section 736 applies to a distribution in redemption of a partner’s interest, but not to a sale of a partnership interest. When a withdrawing partner receives cash in termination of his interest and the interests of the other partners are increased proportionately, a liquidating distribution is indistinguishable from a sale of the withdrawing partner’s interest to the continuing partners. Subchapter K permits the partners to choose whether to treat the transaction as a liquidation or as a pro rata sale of the withdrawing partner’s interest to the remaining partners.\textsuperscript{117} Because the economic consequences of the transaction are normally identical, the

\textsuperscript{115} See ABA § 707 Task Force, supra note 6, at 71-72 (Q&A 92).
\textsuperscript{116} Id. at 72 (Q&A 93).
\textsuperscript{117} See, e.g., Cooney v. Commissioner, 65 T.C. 101 (1975); Foxman v. Commissioner, 41 T.C. 535 (1964) (acq.), aff’d, 352 F.2d 466 (3d Cir. 1965).
form of the transaction, rather than its "substance," is controlling.\textsuperscript{118} If the interests of all the other partners are not increased proportionately, a transaction structured as a liquidation of a partner's interest has all the indicia of a sale. For example, a withdrawing partner may receive a cash liquidating distribution coupled with a contribution shortly before or after by another partner in an amount approximately equal to the liquidating distribution. Based on section 1.731-1(c)(3) of the regulations, the Service has argued that related contributions and distributions should be recast as a sale of a partnership interest between the partners whose interests are shifted. In amending section 707, Congress sought, in part, to reverse the result in two cases where taxpayers had successfully avoided treatment of related contributions-distributions as sales of partnership interests, notwithstanding the regulations.\textsuperscript{119}

In \textit{Communications Satellite Corp. v. United States},\textsuperscript{120} the taxpayer, Comsat, was a member of an international joint venture, INTELSAT, formed under the auspices of the United Nations to operate a communications satellite system. The original members of the joint venture, including Comsat, contributed capital based on their projected use of the system in exchange for percentage interests or "quotas." The quotas of all existing members were reduced pro rata to reflect the quota assigned to the new members on admission. The capital contributions of the new members were set at an amount approximately equal to what they would have contributed as original members, adjusted for prior partnership distributions and interest, to avoid uncertainties in valuing INTELSAT's assets.

The IRS argued that the contribution by the new members, followed shortly thereafter by a distribution to the old members equal to their share of the contributed funds, represented a sale of a portion of the existing members' interests to the new members.\textsuperscript{121} The court held, however, that the "substance" of the transaction was a distribution of partnership property to the existing partners, rather than a sale of partnership interests.\textsuperscript{122} In reaching this decision, the court emphasized the unique character of INTELSAT as an arrangement for promoting international comity and cooperation.\textsuperscript{123} It also noted the absence of negotiations between the incoming partners and the existing members, and any attempt to appraise the value of the partnership interests, as factors not commonly associated with sale transactions.\textsuperscript{124}

\begin{itemize}
\item \textsuperscript{118} See W. McKee, \textit{supra} note 16, ¶ 15.02[3].
\item \textsuperscript{119} \textit{Communications Satellite Corp. v. United States}, 625 F.2d 997 (Cl. Ct. 1980); \textit{Jupiter Corp. v. United States}, 83-1 U.S. Tax Cas. (CCH) ¶ 9168 (Cl. Ct. 1983).
\item \textsuperscript{120} 625 F.2d 997.
\item \textsuperscript{121} \textit{Id.} at 1000.
\item \textsuperscript{122} \textit{Id}.
\item \textsuperscript{123} \textit{Id.} at 1001.
\item \textsuperscript{124} \textit{Id}.
\end{itemize}
In *Jupiter Corp. v. United States*, new partners contributed capital and loaned funds to an existing partnership which used the entire amounts to repay loans from the original partners and to make distributions to such partners. The court specifically rejected the government's argument that section 1.731-1(c)(3) of the regulations required recasting of the contribution and distribution portions of the transaction as a sale of partnership interests. Focusing on the intent of the parties as the principal distinction between sale and contribution-distribution treatment, the court indicated that "[t]he parties must have intended to transfer the partnership interest in the form in which the transaction is cast. The form of the transaction must comport with the intention of the parties." It emphasized that "[t]he parties had legitimate business reasons for structuring the transaction as they did. In fact, the goals sought by the parties could not have been achieved by structuring the transaction as a sale of ... plaintiff's partnership interest." The new partners' interests contained special features, including limited liability and priority distributions, that could not have been obtained by a direct sale of the existing general partnership interest. The contribution form thus enabled the new partners to avoid unlimited liability and permitted the sole original general partner to retain complete management and control. Furthermore, the distribution was pro rata to the original partners based on their pre-contribution interests.

Both *Communications Satellite* and *Jupiter* represent unusual cases because of the closeness in time between the admission of new partners and the receipt by the old partners of pro rata distributions nearly equal to the contributions of the new partners. Although adjustment of the partnership interests of the old partners contemporaneously with the admission of new partners may be desirable for bookkeeping purposes, there is often no business necessity to make immediate distributions to the old partners. As long as the old partners receive adequate compensation for their disproportionate capital investment in the partnership, a distribution to them to reflect the altered interests in the partnership can ordinarily be postponed until a later date. It is correspondingly more difficult to characterize the overall transaction as a sale of partnership interests if sufficient time elapses between the contributions and distributions. Classification as a sale of partnership interests also becomes more tenuous when the distributions to the existing partners are non-pro rata or occur in installments over a period of time. As in *Jupiter*, the inference of a sale of partnership interests can be weakened when the contribution-distribution results in admission of a new partner with

126. *Id.* at 86,301.
127. *Id.* at 86,299.
128. *Id.* at 86,300.
an interest in the partnership different from the existing interests of the other partners.\(^{129}\)

**B. Legislative Reversal of Communications Satellite and Jupiter: New Section 707(a)(2)(B)**

In amending section 707, Congress sought to prevent contribution-distribution treatment in cases like *Communications Satellite* and *Jupiter*.\(^{130}\) Thus, a contribution and distribution coupled with a liquidation or reduction of an existing partner's interest will apparently result in sale treatment. Similarly, sale treatment will occur when a contribution by a new partner is coupled with a pro rata distribution to other partners in partial liquidation of their partnership interests. However, the effect of amended section 707(a)(2)(B) on the traditional flexibility allowed partners in characterizing a termination of an existing partner's interest as a section 736 liquidation or a section 741 sale of a partnership interest is unclear. Although Congress did not identify such transactions as abusive, the language of section 707(a)(2)(B) is sufficiently broad to encompass them. Even if the disguised sale rules do not reverse the principle that partners may in effect choose to be taxed under section 736 or section 741 upon a withdrawal of a partner, the regulations may well contain anti-abuse provisions.

The legislative history seems to indicate that disguised sale treatment will depend on whether the source of the distribution is capital contributed by new partners.\(^{131}\) Assume that equal partnership *AB*, with a net worth of $300, admits *C* as an equal one-third partner in exchange for a cash contribution of $100. Immediately thereafter, the *ABC* partnership makes a cash distribution of $50 each to *A* and *B*. The contribution and distribution, when viewed together, will be treated as a sale by *A* and *B* of one-third of their respective 50% partnership interests to *C* for $50. Disguised sale treatment would apparently not result, however, if the *AB* partnership made a $50 pro rata distribution to each of the existing partners from available partnership cash accumulated prior to the admission of *C*, even though the result is economically the same.

A distribution of excess cash from partnership borrowings incurred in anticipation of the admission of new members will generally trigger disguised sale treatment. The new partner should be considered to have made an indirect contribution to the partnership to the extent that such partner's share of liabilities is increased under section 752.\(^{132}\) For purposes of the disguised sale provisions, the other partners should be treated as having sold

\(^{129}\) See W. McKee, *supra* note 16, ¶ 15.02[3][A].

\(^{130}\) See Comm. Print, *supra* note 4, at 225.

\(^{131}\) Id.

\(^{132}\) See N.Y. Bar Comments, *supra* note 6, at 42.
a portion of their partnership interests to the extent that the constructive section 752 distribution is accompanied by an actual cash distribution related to admission of the new partner. For example, assume that the AB partnership borrows $150 in anticipation of C’s admission. C would be treated as having made an indirect contribution of $50 (one-third of the liabilities) and A and B would each be treated as having received a constructive section 752 distribution of $25 (one-half of the liabilities assigned to C). If the partnership distributes $50 to A and B each, the portion of the actual cash distribution treated as deemed sales proceeds will apparently be limited to $25; in effect, the constructive section 752 distribution represents a “ceiling” on the recharacterized portion of the distribution. The remaining portion of the cash distribution, which falls outside section 707, will be taxed under the normal distribution rules of section 731. Accordingly, A and B may each avoid deemed sale treatment on a portion of the actual cash distribution, even though the entire $50 distribution would be treated as deemed sale proceeds if derived from C’s capital contribution rather than partnership borrowing.

If C’s $100 cash contribution is actually used to retire $100 of the partnership’s outstanding liabilities pursuant to a prearranged plan, A and B would each be treated as receiving additional constructive section 752 distributions of $33.33 (one-third of the retired liabilities). Since the total section 752 reduction in partnership liabilities allocable to A and B now exceeds the amount of actual cash received by them, the entire $50 distribution should be taxed as disguised sales proceeds. As this example illustrates, the tax treatment of the distributee partner’s may be significantly different depending on both the source of the actual cash distribution—partnership borrowing or contributions of other partners—and the eventual use of contributed capital to retire partnership debt pursuant to a related contribution-distribution.

The order in which partnership debt is incurred and the new member admitted may also produce radically different tax consequences, even though the timing of events may often have no independent significance. For example, assume that the AB partnership has no preexisting liabilities at the time of C’s admission, and thereafter borrows $150 and distributes $50 each to A and B. In this event, the entire $50 cash distribution would apparently be governed by section 731 rather than section 707, since there is no constructive section 752 distribution. Alternatively, the AB partnership could incur $100 of liabilities prior to C’s admission, distribute $50 of cash each to A and B, and then incur an additional $50 of partnership liabilities in conjunction with C’s admission. Although this technique would apparently

133. Id.
134. See supra notes 84-86 and accompanying text.
suffice to avoid a constructive section 752 distribution, the regulations may provide anti-avoidance rules to deal with such situations.

Consistent with the legislative intent, disguised sale treatment should not result from a deemed section 752 distribution unless there is also an actual cash distribution and a change in the partner’s interests in the partnership.\(^\text{135}\) If a constructive section 752 distribution were viewed as sufficient by itself to give rise to deemed sale treatment, virtually any admission of new partners would trigger application of section 707. It is unlikely, however, that Congress intended to alter the normal rule that the admission of new members does not constitute a sale or exchange of partnership interests. The section 707 regulations should therefore clarify that a constructive section 752 distribution on admission of new partners will generally not be treated as a sale or exchange.

Section 707 classification might otherwise cause an inadvertent termination of the partnership under section 708 because of a constructive section 752 distribution on admission of new partners. Under section 708(b)(1)(B), a termination of a partnership is triggered by a “sale or exchange” of 50% or more of the total interests in partnership capital and profits within a twelve-month period.\(^\text{136}\) The section 708 regulations provide generally that neither the liquidation of a partnership interest by the partnership, nor the acquisition of a partnership interest by a contribution of property, constitutes a sale or exchange for purposes of section 708(b)(1)(B).\(^\text{137}\)

The section 707 regulations should also clarify the relationship of the disguised sale rules with the normal rules under section 736 governing payments in liquidation of a retiring partner’s interest. Present law appears to permit partners complete freedom of choice between structuring a payment to a retiring partner as a section 736 redemption or a section 741 sale of a partnership interest.\(^\text{138}\) Unfortunately, the legislative history offers no guidance concerning the complex interaction between the disguised sale rules of section 707 and section 736. One approach would be to exempt any purported section 736 liquidation from the disguised sale rules of section 707, on the ground that the coexistence of section 736 and section 741 manifests a policy determination to permit partners to elect non-sale treatment when a partner’s interest in a partnership is retired.

If the regulations instead adopt the position that section 707 may apply to a purported section 736 liquidation, some exception for constructive section 752 distributions may, nevertheless, be appropriate.\(^\text{139}\) For example, assume that a partner’s interest in the partnership is liquidated under section

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135. See N.Y. Bar Comments, supra note 6, at 42.
138. See supra note 117 and accompanying text.
139. See N.Y. Bar Comments, supra note 6, at 43.
736 in connection with the admission of new members in a transaction which also triggers a constructive section 752 distribution. If the retiring partner receives only a deemed distribution of cash, disguised sale treatment should not result under the rules discussed above. If the retiring partner receives both actual cash and a deemed cash distribution, however, it is unclear whether relief from the disguised sale rules is appropriate.

To avoid the inherent complexity of integrating the already intricate rules of sections 707, 736, and 752, the regulations may well offer such relief. Accordingly, the regulations may provide a safe harbor exempting such transactions from section 707 to the extent that: (1) a distribution is made pursuant to a section 736 liquidation of a partner's interest and (2) a deemed sale would otherwise result only by virtue of indirect contributions of other partners which are deemed to occur under section 752 as a result of a shift of preexisting liabilities to other partners. Assuming that the regulations adopt the proposed safe harbor rule in connection with a liquidation of a partner's interest under section 736, the question arises whether similar relief should be provided to any distribution incident to liquidation of a partner's interest, even if the distribution is not governed by section 736. For example, a general partner may receive some cash and have the balance of his partnership interest converted into a limited partnership interest in a transaction that would normally constitute a tax-free exchange of interests in the same partnership. If the conversion of the general partnership interest into a limited partnership interest also triggers a constructive section 752 distribution, relief from the disguised sale provisions should arguably be available to the same extent as if the liquidation of the old general partnership interest were governed by section 736.

Regardless of the extent to which the section 707 regulations may provide limited relief in the circumstances described above, they should clarify the application of section 707 and section 736 in some common situations involving the retirement of a partner's interest in conjunction with the admission of new members. For example, assume that a partnership is formed with A as sole general partner and A's wholly-owned corporation, X, as the sole limited partner. A owns 20% and X owns 80% of the partnership interests. The partnership admits twenty new limited partners who each contribute $100 and receive a 4% partnership interest. X withdraws as a partner in return for a cash distribution equal to its original capital contribution plus an additional amount representing interest on X's contributed

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140. See supra notes 133-37 and accompanying text.
141. See N.Y. Bar Comments, supra note 6, at 43-44.
142. Id.
143. See, e.g., Rev. Rul. 84-52, 1984-1 C.B. 157 (conversion of general partnership interest into a limited partnership interest in the same partnership is a tax-free contribution under section 721; gain or loss will be recognized, however, to the extent provided in section 731).
capital. Since $X$ acted merely to facilitate formation of the partnership and the cash distribution does not exceed $X$'s original contribution plus interest, the admission of new partners and withdrawal of $X$ should not be subject to section 707(a)(2)(B).\textsuperscript{144} If $X$ also receives an additional payment representing an organization or syndication fee as compensation for $X$'s services in forming the partnership, the result should be the same.\textsuperscript{145}

The regulations should also clarify the potential application of the disguised sale rules when a partner contributes appreciated property in exchange for a partnership interest and has a right to withdraw from the partnership in return for a fixed liquidating distribution. If the partner's right to receive the liquidating distribution is subject to the risk of the partnership's business, the liquidating distribution will presumably be treated under the normal rules of sections 731 and 736. For example, assume that $A$ joins partnership $ABC$ by contributing an appreciated building, and $B$ and $C$ contribute cash which the partnership uses to rehabilitate $A$'s building. According to the partnership agreement, $A$ has the right to withdraw from the partnership when the rehabilitation is completed and receive a liquidating distribution equal to twice the value of his original capital contribution. Because the liquidating distribution to $A$ should generally be viewed as subject to material entrepreneurial risk, section 707 classification as a disguised sale of property or a partnership interest does not seem appropriate.\textsuperscript{146}

The classification issue is less clear if $A$ has the right to withdraw only if the partnership is syndicated and a substantial portion of the partnership interests are sold to new investors. In this situation, section 707(a)(2)(B) may treat $A$ as having sold his entire partnership interest to new investors, given Congress' disapproval of the results in \textit{Communications Satellite} and \textit{Jupiter}. To avoid disguised sale treatment, the partners should try to ensure that the source of the distribution is partnership funds and not capital contributed by the new investors.\textsuperscript{147}

IV. \textsc{Alternative Approaches to Organizational Transfers}

A. \textit{Inadequacy of Existing Approach}

Consistent with the legislative history, this Article has argued that the proposed regulations should adopt an approach which reflects the underlying purpose of section 707(a)(2) as an anti-abuse provision. The disguised sale provisions are intended to recharacterize certain transactions between a partnership and a partner to reflect their economic substance in situations in

\textsuperscript{144} See ABA § 707 Task Force, \textit{supra} note 6, at 65 (Q&A 81).
\textsuperscript{145} \textit{Id.} at 64-65 (Q&A 80).
\textsuperscript{146} \textit{Id.} at 68-69 (Q&A 86).
\textsuperscript{147} See W. McKee, \textit{supra} note 16, ¶ 13.02[5][b].
which the general partnership rules should not apply. Unless the forthcoming section 707 regulations are narrowly drafted to reflect this anti-abuse purpose, there is a danger that the disguised sale provisions may be interpreted more broadly than Congress intended, in a wide range of nonabusive partner-partnership transactions.

One issue that must be faced squarely is whether detailed regulations implementing the disguised sale provisions are likely to encounter problems similar to those under the abortive section 385 debt-equity regulations.148 The problem of distinguishing debt from equity in the corporate context is analogous to the difficulties inherent in distinguishing sales from contributions-distributions in the partnership context. Having dodged the task of providing a statutory distinction between debt and equity in 1954, Congress decided in 1969 to turn the issue over to the Treasury by enacting section 385.149 It authorized the Treasury to issue regulations defining corporate stock and debt by reference to factors that might, but need not, be considered in the section 385 regulations. Although Congress believed that precise statutory definitions were susceptible of circumvention in the debt-equity area, it failed to explain why regulations might not be frustrated in the same manner. If the example of the section 385 regulations provides any guidance to the likely fate of the section 707 regulations, it may be that the Treasury will prove no more successful than Congress in resolving difficult definitional issues.

Although the statutory provisions concerning disguised sales were enacted more than three years ago, no regulations have yet been issued. Given the inherent difficulty of distinguishing sales from contributions-distributions, it might be argued that the Treasury should refrain from providing detailed rules and instead issue merely a prophylactic warning that abusive transactions which resemble sales will be treated accordingly. The difficulty with this approach, however, is that it has already been tried unsuccessfully. Consistent with the congressional mandate in the 1984 Act, the Treasury must therefore address the sale-contribution classification issue, even though the regulations may be frustrated in practice by the variety and complexity of partner-partnership transactions.

B. Immediate Sale Approach

Congress should seriously consider whether alternative approaches to the treatment of partnership organizational transfers are available to cure the disguised sale problem. One such approach would be to treat any contribution

148. See N.Y. Bar Comments, supra note 6, at 26.
to a partnership as an immediate sale event.\textsuperscript{150} Traditionally, section 721 nonrecognition treatment has been justified on the theory that individual ownership of the property is deemed to continue under an aggregate approach to partnerships. The contribution of property to a partnership is viewed as a mere change in the form of ownership, rather than a substantive alteration in the nature of the underlying investment.\textsuperscript{151} Current law seeks to distinguish between contributions-distributions which are treated as sales under an entity approach and those which are treated as tax-free contributions followed by distributions under an aggregate approach.

If a pure entity approach were taken toward organizational transfers to a partnership, the contributing partner would be treated as exchanging a direct ownership interest in the contributed property for a partnership interest.\textsuperscript{152} The entity view of organizational transfers would justify treating a contribution to a partnership as a "partial" or "full" sale of the contributed property to the other partners.\textsuperscript{153} Under a partial sale approach, the contributing partner would be treated as selling only a proportionate interest in the contributed property to the other partners, and retaining a direct ownership interest in a portion of the contributed property. Under a full sale approach, the contributing partner would be treated as selling the entire property to the partnership at its fair market value in exchange for a partnership interest in the partnership's assets. Theoretical consistency requires imposition of full, rather than partial, sale treatment under an entity approach.\textsuperscript{154}

If a partner contributes appreciated property to a partnership and the other partners contribute solely cash, the transaction strongly resembles a partial or complete liquidation of the contributed investment and the substitution of a new investment. Immediate sale treatment accurately reflects the substantive economic alteration in the taxpayer's investment, and avoids deferral of gain to the contributing partner. Application of an immediate sale approach in other circumstances, however, may appear excessively harsh. For example, when two partners each contribute unimproved land to a partnership in exchange for 50% partnership interests, immediate sale treatment is less clearly justified. A direct exchange of one-half of each partner's

\textsuperscript{150} See Postlewaite, supra note 8, at 464-74; Keyser, supra note 8.

\textsuperscript{151} See Magneson v. Commissioner, 753 F.2d 1490, 1498 (9th Cir. 1985), aff'd 81 T.C. 767 (1983) (like-kind exchange of property followed immediately by contribution to a partnership was a change in the form of ownership rather than a relinquishment of ownership).

\textsuperscript{152} See Magneson v. Commissioner, 81 T.C. 767, 779 (1983) (Tannenwald, J., dissenting) (the "transformation of the [taxpayers'] outright ownership of an interest in real property into a partnership interest" was a substantive change in the form of investment).

\textsuperscript{153} See Keyser, supra note 8, at 293 (partial sale approach); Postlewaite, supra note 8, at 465 (full sale approach).

\textsuperscript{154} See Postlewaite, supra note 8, at 465-66; Keyser, supra note 8, at 294 (acknowledging that the logical implication of an entity approach is a full sale model, but opting for a "gentler rule" in light of practical considerations).
land for a one-half interest in the other partner’s land would normally qualify as a nonrecognition event under section 1031, subject to the strict boot recognition rules.\textsuperscript{155} In contrast to section 1031, however, section 721 allows nonrecognition treatment even when the underlying partnership property includes cash or other non-like-kind property that would trigger boot recognition under section 1031. Thus, the nonrecognition provisions of section 721 are generally more liberal than those of section 1031.\textsuperscript{156}

Although immediate sale treatment may be justified under a strict entity approach, other policy considerations might require relief from full taxation of the contributing partner’s gain. The nonrecognition provisions of the Code—including sections 721, 351, and 1031—have traditionally been defended on three grounds: (1) valuation difficulties, (2) lack of liquidity, and (3) lock-in effect on investments.\textsuperscript{157} Valuation difficulties should not be viewed as an insurmountable objection to immediate sale treatment in the partnership context, since section 704(c) and the final section 704(b) regulations generally require valuation of contributed property.\textsuperscript{158} In order to eliminate disparities between book and tax accounts, these rules require that a partner’s capital account be credited with the fair market value, rather than the transferor’s tax basis, of contributed property.

Indeed, the decision in the final section 704(b) regulations to abandon tax-basis capital accounts as the cornerstone of the economic effect test for partnership allocations may be traced primarily to the mandatory special allocation rules of section 704(c) as enacted by the 1984 Act. By contrast, the proposed section 704(b) regulations promulgated in 1983 established a general rule that property contributions be booked at their tax basis, rather than agreed value, except under narrowly defined circumstances. The approach of the proposed regulations was strongly influenced by perceptions of the opportunities for abuse if partners were permitted to establish capital accounts, and hence section 704(b) loss allocations, based on an agreed value of property.\textsuperscript{159} This approach was apparently abandoned primarily because of the enactment of section 704(c), which was aimed at a different kind of abuse. Although valuation difficulties may still exist, particularly when partners contribute multiple assets to a partnership, the final section 704(b) regulations thus open the way to an immediate sale approach by requiring valuation.

\begin{itemize}
\item \textsuperscript{155} See I.R.C. § 1031(b) (gain recognized from exchanges not solely of like-kind property).
\item \textsuperscript{156} See Burke, supra note 63, at 491.
\item \textsuperscript{157} See Keyser, supra note 8. See also Jensen, The Uneasy Justification for Like-Kind Exchanges, 4 Am. J. Tax Pol’y 193, 193-215 (1985) (arguing that justification for like-kind treatment is “uneasy,” but concluding that retention of section 1031 is desirable). Cf. Kornhauser, Section 1031: We Don’t Need Another Hero, 60 S. Cal. L. Rev. 397 (1987) (describing current attitude toward section 1031 as “hero worship”).
\item \textsuperscript{158} See Keyser, supra note 8, at 292-93.
\item \textsuperscript{159} See W. McKee, supra note 16, \textsuperscript{10.01A[1]}.
\end{itemize}
Objections to an immediate sale approach based on lack of liquidity ignore the underlying economic reality that a contributing partner has deliberately chosen to transfer appreciated property to a partnership, thus achieving a pooling of risks and relinquishing some of the benefits/burdens associated with the original investment. The ability-to-pay argument also has been criticized on the ground that it unfairly discriminates against investors who actually liquidate their investment and reinvest the after-tax proceeds.

Business realities also undermine concerns about lack of liquidity. Several alternatives would presumably continue to exist whereby the parties could avoid immediate taxation. The putative partner could lease the property to the partnership or, if efficient operation of the partnership business required acquisition of the property, the property could be sold to the partnership under the installment method. In an installment sale, the transferor would be required to recognize gain only in the year in which actual cash payments were received in proportion to his gross profit ratio. Deferral of gain recognition would continue, albeit under a Code provision other than section 721, and the partnership would obtain a stepped-up basis in the contributed property.

In effect, the partners would be permitted to elect to defer gain under the installment method or to recognize gain immediately on a taxable contribution. Thus, an immediate sale approach would preserve the substantive economic distinction between a sale and a contribution based on whether the other partners are guaranteeing payment for the contributed property or whether the contributing partner bears a material entrepreneurial risk of nonpayment. If property is sold on credit to the partnership, the parties would be required to document the transaction as a sale in order to obtain the benefit of installment deferral. If the transfer is structured as a contribution rather than a credit sale, deferral would not be permitted, on the ground that nonrecognition treatment is incompatible with an entity approach, even though the contribution is admittedly not a sale.

Although critics are likely to object to an immediate sale approach because of the potential lock-in effect on investments, the lock-in argument is suspect. Imposition of tax on asset conversions necessarily discourages any switch from a lower to a higher yielding asset, to some extent. Moreover, preferential treatment of certain transactions as nonrecognition events may simply encourage conversion of assets into other tax-favored forms which

160. See Keyser, supra note 8, at 288-89.
161. Id. at 290.
162. See Postlewaite, supra note 8, at 472.
163. Id. at 477 ("the different tax consequences accorded to contributions and sales merely reflect substantive economic differences" under state partnership law). Cf. Keyser, supra note 8, at 270 (distinction between sales and contributions is "illusory").
164. See Postlewaite, supra note 8, at 478-79.
165. See Keyser, supra note 8, at 290-91.
would not be economically justified if imposition of a tax on conversion were the general income tax rule. Historically, the potential lock-in effect has been considered sufficiently serious to justify preferential treatment of capital gains, however. Although this approach is presently in abeyance, concern about the lock-in effect may warrant rejection of an immediate sale approach, at least without further intensive rethinking of the direction in which the income tax should currently be moving. If a consumption tax is the appropriate model, the current nonrecognition provisions should generally be retained because they point in this direction. Aside from speculations concerning the direction of an ideal tax system, however, the reasons for tentatively rejecting an immediate sale approach can be stated on narrower grounds, specifically concerning the implications of an immediate sale approach for the existing framework of Subchapter K.

This Article has argued that an immediate sale approach would be attractive precisely because it might lead to a much-needed substantial simplification of the provisions of Subchapter K without introducing any additional complexities. Under section 704(c) and the final section 704(b) regulations, valuation of contributed property is required whenever organizational transfers occur upon formation of a partnership. The viability of an immediate sale approach to organizational transfers, however, requires analysis of its implications for post-formation transfers as well.

The logical implication of a strict entity approach to organizational transfers, when a contribution occurs after formation, would be to treat the existing partnership as if it had been dissolved and a new partnership had been formed. Accordingly, the “old” partnership should recognize gain or loss on appreciated or depreciated partnership property whenever a new member is admitted. Treatment of post-formation transfers as an immediate recognition event would ensure consistent tax treatment regardless of whether the new member acquires his partnership interest by “purchase” or “contribution.” Regardless of the form of the transaction, a strict entity approach to organizational transactions requires that the admission of a new member be treated as a full recognition event to both the partnership and the new member.

For example, assume that A and B initially form a partnership to which A contributes $6,000 cash and B contributes appreciated land with a basis of $3,000 and a fair market value of $6,000, in exchange for equal partnership

166. See id. at 283 (“any workable model of a consumption tax would include just such a principle of nonrecognition”). See, e.g., Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 HARV. L. REV. 1113 (1974).
168. See Postlewaite, supra note 8, at 470.
169. Id.
170. Id.
interests. Under an immediate sale approach, B must pay tax on the $3,000 gain inherent in the contributed property, and the partnership receives a fair market value basis in the contributed property. The partnership interests of A and B will also have a basis equal to fair market value, thereby ensuring equality between the partners' basis in their partnership interests ("outside basis") and their share of the partnership's basis in its assets ("inside basis").

Assume further that C is admitted to the partnership as an equal one-third partner six months later, when the partnership's land has a fair market value of $12,000, in exchange for a contribution of $9,000 cash. A strict entity approach to this post-formation transfer would require that partnership AB recognize $6,000 of gain (allocated $3,000 to A and $3,000 to B) on admission of C to the new ABC partnership. The ABC partnership would take a $12,000 basis in the land, and each partner would have a capital account and tax basis for his partnership interest equal to $9,000, the fair market value of the partnership interest. This result is proper under a strict entity approach to organizational issues "because, in essence, the old partnership is being dissolved and a new partnership is being formed."

Rigorous application of a strict entity approach thus requires full and immediate taxation of all appreciation in partnership assets occurring prior to the new partner's admission. Even a de minimis contribution of cash or property by an incoming partner would, in theory, require full gain recognition to the partnership. This result is theoretically proper because partial gain recognition can only be justified under an aggregate approach, the antithesis of an entity approach. Predictably, if full gain recognition were the rule for post-formation transfers, existing partnerships would choose to raise additional capital for expansion or efficient operation of existing businesses through borrowing, whenever possible, rather than through new equity infusions, because the former method would be nontaxable while the latter method would not. Although the corporate tax rules already exhibit a decided bias in favor of debt as opposed to equity, it is doubtful whether it is economically desirable to superimpose a similar bias on the partnership tax rules.

It might be thought possible to avoid this problem by modifying the entity approach to post-formation transfers when the incoming partner contributes only a de minimis amount of cash or property, if theoretical consistency were the only consideration involved. Unfortunately, the problem goes much

171. Id. at 470-71.
172. Id. at 471.
173. Id.
deeper, and ultimately reflects the ambivalence with respect to entity-aggregate treatment that pervades Subchapter K. The underlying problem inheres in the vexing complexities and distortions that arise whenever a partner's outside basis differs from his share of the partnership's inside basis. A strict entity approach to organizational transfers has the potential to simplify Subchapter K significantly by eliminating the possibility of a discrepancy between inside and outside basis.\textsuperscript{175} Under an immediate sale approach, equality of inside and outside basis is automatically established at the price of immediate taxation of unrealized appreciation inherent in contributed property.

Unless post-formation transfers are treated with the same rigor as formation transfers, however, the initial equality between inside and outside basis will break down. The reason is that a contribution to an existing partnership with appreciated property is really the equivalent of a formation of a new partnership to which the existing partners contribute the old partnership's appreciated property and the incoming partner contributes other property. The final section 704(b) regulations recognize this equivalence by requiring so-called "reverse section 704(c) allocations" whenever a new member is admitted to an existing partnership owning property with a tax basis other than its fair market value at the time of contribution.\textsuperscript{176} Although reverse section 704(c) allocations are expressly governed by the final section 704(b) regulations, rather than by section 704(c) itself, the results are generally identical. Therefore, unless post-formation transfers are treated as triggering full gain recognition to the existing partnership, resulting disparities between book and tax accounts can be eliminated only by retention of rules analogous to present section 704(c).

Accordingly, full recognition of gain on post-formation transfers is essential to achieve potential simplification of Subchapter K in the form of a repeal of present section 704(c) without reintroducing the abuses at which section 704(c) is aimed. The egregious complexities produced under present Subchapter K by the interplay of the aggregate approach of section 704(c) and the entity approach of the so-called "ceiling rule," have been explored at length elsewhere.\textsuperscript{177} An immediate sale approach offers an opportunity to eliminate these distortions because it recognizes the separate entity character of partnerships in the context of organizational transfers. Indeed, the immediate sale approach is one of the cornerstones of a recent comprehensive critique of the aggregate view taken by the ALI in its Subchapter K project.\textsuperscript{178}

\begin{footnotesize}
\begin{enumerate}
\item See Postlewaite, supra note 8, at 479.
\item See Treas. Reg. § 1.704-1(b)(5) Example 14 (1987) (restatement of partners' capital account or, alternatively, special allocation of pre-contribution gain required when new partners admitted).
\item See Marich & McKee, supra note 32.
\item See Postlewaite, supra note 8.
\end{enumerate}
\end{footnotesize}
The ALI project took "as a basic assumption" that, "in the absence of countervailing factors," partners should ideally be treated as if they were conducting a proportionate share of the partnership's business. Thus, the ALI project sought to assimilate the partnership model as nearly as possible to a pure aggregate approach, recommending entity-based rules only in those situations in which an aggregate approach would lead to undue complexity or potential abuse. The recent critique of the ALI project abandons the underlying aggregate model of partnership taxation and proceeds instead from a "transaction oriented perspective."

Although this conceptual critique of the ALI's aggregate model has considerable analytical force and potential for simplification of Subchapter K, this Article has suggested that an entity view of organizational transfers raises serious lock-in problems. To achieve its intended purpose, the entity approach must necessarily be applied to both formation and post-formation transfers. Even if the lock-in problem is viewed as manageable with respect to formation transfers, an immediate sale approach should be rejected with respect to post-formation transfers because of the more serious lock-in problems arising when an existing partnership with appreciated property admits new members. If an immediate sale approach is not feasible with respect to post-formation transfers, however, it should not be applied to formation transfers either.

C. Deferred Sale Approach

If the price of simplification of Subchapter K through imposition of an immediate sale approach is excessively high, more modest solutions to the disguised sale problem must be sought. One approach would be to seek perfection of the section 707 regulations. However, as this Article illustrates, perfection of such regulations will not be an easy task; and it may not be unreasonably pessimistic to speculate that the section 707 regulations, when finally issued, may suffer the fate of the abortive section 385 regulations. Fortunately, there is a less radical alternative to an immediate sale approach which is feasible, consistent with the present nonrecognition policy of section 721 and the goal of simplicity: namely, a "deferred sale" approach. Although a deferred sale approach can cure the disguised sale problem, it should be implemented only in conjunction with a rationalization of the distribution rules of Subchapter K.

A "deferred sale" approach to organizational transfers was originally proposed by the ALI study of Subchapter K. Although the ALI ultimately

179. ALI TAX PROJECT, supra note 6, at 5 (emphasis added).
180. Postlewaite, supra note 8, at 426.
181. ALI TAX PROJECT, supra note 6, at 129-31.
decided to reject the deferred sale approach, it did so on grounds that such an approach would lead to additional complexity and valuation difficulties.\textsuperscript{182} More recently, the deferred sale approach has been revived as a proposed optional or mandatory cure for existing complexities attributable to the interaction of section 704(c) and the ceiling rule.\textsuperscript{183} The deferred sale approach reflects essentially an aggregate approach, but is sensitive to ceiling rule problems resulting from the entity approach to determinations of depreciation and gain or loss at the partnership level.\textsuperscript{184} Accordingly, the deferred sale approach should no longer be viewed as a source of additional complexity, but rather as a cure to existing complexities caused by the ceiling rule limitation on section 704(c) allocations.\textsuperscript{185} Moreover, the valuation difficulties feared by the ALI are already present under section 704(c) and the final section 704(b) regulations.\textsuperscript{186} Therefore, the ALI’s original grounds for rejecting the deferred sale approach—additional complexity and valuation difficulties—are no longer controlling. Rather, the deferred sale approach offers hope for restoring coherence to Subchapter K.

The ALI recognized that a deferred sale or “credited value” approach “permits the simplicity and correctness of result that are available if the formation of a partnership is treated as taxable,” but achieves these benefits “without . . . the deterrent effect on partnership formation that will result if gain is immediately recognized.”\textsuperscript{187} Under the “partial” deferred sale approach as originally recommended by the ALI, the contributing partner would be treated as though, at the time of contribution, he had sold an undivided portion of the contributed property, but recognition of gain or loss would be deferred.\textsuperscript{188} This version of the deferred sale approach is potentially complex, however, because it would be necessary to keep track of each partner’s separate basis in the contributed property.\textsuperscript{189} The noncontributing partners would acquire a cost basis in the contributed property, while the contributing partner would have a carryover basis in the retained portion. More recently, in 1984, the ALI proposed a simpler alternative referred to as a “full” deferred sale approach.\textsuperscript{190} Although the full deferred sale approach has been objected to as a modification of a strict aggregate

\begin{itemize}
\item \textsuperscript{182} Id. at 129.
\item \textsuperscript{183} Marich & McKee, supra note 32, at 682-87.
\item \textsuperscript{184} Id. at 684.
\item \textsuperscript{185} Id. at 686 (deferred sale approach “could provide the tonic for a source of truly distressing complexity, the ceiling rule”).
\item \textsuperscript{186} See supra note 167 and accompanying text.
\item \textsuperscript{187} ALI Tax Project, supra note 6, at 129.
\item \textsuperscript{188} ALI Federal Income Statute 354 at 354-56 (Feb. 1954 Draft); Marich & McKee, supra note 32, at 682.
\item \textsuperscript{189} See Marich & McKee, supra note 32, at 683.
\item \textsuperscript{190} ALI Tax Project, supra note 6, at 129.
\end{itemize}
approach," it actually represents merely a "simpler, more flexible means of implementing a deferred sale approach." On grounds of simplicity and workability, therefore, the full deferred sale approach should be adopted rather than the partial deferred sale approach.

Under the full deferred sale approach, the contributing partner would be treated as if he had sold the contributed property to the partnership at its fair market value. The partnership would receive a basis in the contributed property equal to its fair market value, and deferred gain or loss would be allocated to the contributing partner based on the difference between the basis and fair market value of the property at the time of contribution. Consistent with the underlying nonrecognition policy of section 721, the full deferred sale approach would postpone recognition of the contributing partner's gain or loss until the partnership disposed of the property or the partner disposed of his partnership interest. In the case of depreciable property, a portion of the contributing partner's deferred gain or loss would be recognized each year over the remaining depreciable life of the property. By requiring the contributing partner to bear the benefits/burdens of any disparity between the basis and fair market value of the contributed property, the full deferred sale approach would effectively implement the underlying goal of section 704(c). It would also rectify distortions caused by the ceiling rule limitation on section 704(c) allocations, thereby restoring equality between inside and outside basis.

Deferral of gain on contributed property would continue as under present section 721, but recognition of gain would be accelerated to the extent that the contributing partner would effectively be allocated a larger stream of taxable income until any book-tax disparity is entirely eliminated. If a contributing partner's interest in the partnership is reduced through a non-pro rata distribution, such as a disguised payment for contributed property, the distribution would be treated as triggering deferred gain to the extent of the percentage reduction in the partner's partnership interest. This result is proper because a non-pro rata distribution can be viewed as a partial or complete liquidation of a partnership interest, and is economically equivalent to a sale of a portion of the underlying partnership assets in which the distributee's interest is terminated.

191. N.Y. Bar Comments, supra note 6, at 12 n.5 (full deferred sale treats the contributing partner as selling a portion of the property to himself or treats the partnership as if it were an entity rather than an aggregate).
193. ALI TAX PROJECT, supra note 6, at 129.
194. Id.
195. Id.
196. See Marich & McKee, supra note 32, at 686.
197. See Postlewaite, supra note 8, at 594-611.
Under a deferred sale approach, similar results would obtain whenever a new partner is admitted to an existing partnership with appreciated property. The ALI recognized that, if a deferred sale approach were adopted for property contributions on formation of a partnership, it would be "desirable to apply a parallel rule when a new partner is admitted to an existing partnership, even if the only asset he contributes is cash." The ALI considered that application of a deferred sale approach to post-formation transfers, however, "could become exceedingly complex, especially for partnerships with a number of partners and many appreciated and depreciated properties.

The concerns should no longer be viewed as an obstacle to adoption of a full deferred sale approach. By requiring reverse section 704(c) allocations whenever property is contributed to an existing partnership with appreciated or depreciated property, the final section 704(b) regulations facilitate a full deferred sale approach to post-formation transfers.

When property is contributed to an ongoing partnership, the existing partners would be treated as if they had made a fresh contribution of the old partnership's property to a new partnership. Any unrealized gain inherent in the old partnership's property would continue to be deferred under principles analogous to present section 721, and would be allocated to the old partners in accordance with section 704(c) principles. A non-pro rata distribution to the existing partners would trigger a proportionate amount of the deferred gain. Again, this result is proper because a contribution-distribution on admission of new members is economically equivalent to a sale of a portion of the existing partners' partnership interests to the new partners, and should be taxed accordingly.

The deferred sale approach outlined above should be implemented, however, only in conjunction with further reform of the partnership distribution rules. The existing distribution rules offer opportunities for abuse, quite apart from the disguised sale problem perceived by Congress. Partners are effectively permitted under the general rules of Subchapter K to elect between treating a terminating distribution to a partner as a liquidation under section 736 or a sale under section 741, with radically different tax consequences.

This ability to elect tax consequences is unjustified, since a complete liqui-
Disguised sale of a partner's interest in the partnership is economically equivalent to a sale of that interest to the existing partners.

In its study of Subchapter K, the ALI proposed a "full-fragmentation" approach to all cash distributions which result in a complete termination of a partner's interest in a partnership. 204 Under the full-fragmentation approach, a liquidation of a partner's interest would be taxed equivalently to a sale of a partnership interest. A liquidation or sale would each trigger gain recognition at the partnership and partner levels respectively, as if a portion of the partnership property had been sold and the proceeds distributed to the partner disposing of his interest in those assets. 205 The ALI considered that the full-fragmentation approach represented a simpler method of evaluating a sale of a partnership interest than the existing collapsible partnership rules of section 751, and would therefore be "much more likely to be applied in practice." 206 The collapsible partnership rules are intended to prevent the parties from converting ordinary gain from unrealized receivables and substantially appreciated inventory into capital gain. When the collapsible partnership rules were enacted in 1954, this limited fragmentation of the proceeds from sale of a partnership interest was intended to minimize the need to value most partnership assets. 207 Because of the expansion of ordinary income assets subject to section 751 treatment, however, it is generally impossible to avoid a detailed asset valuation when a partnership interest is sold. The collapsible partnership rules of section 751 therefore no longer accomplish their original goal, and add considerably to the complexity of Subchapter K.

The ALI proposals would repeal most of section 736, but continue to preserve the option of section 736(a) treatment for goodwill payments to general partners in partnerships in which capital is not a material-income producing factor. 208 Although outright repeal of section 736 may be preferable, 209 the conversion and timing problems may be viewed as less serious in the case of primarily service partnerships where retirement payments are likely to be attributable to deductible unrealized receivables. In capital-intensive partnerships, the ALI perceived that the existing rules of section 736 were subject to manipulation by permitting the parties to determine whether payments attributable to partnership goodwill should be taxed as

204. See ALI Tax Project, supra note 6, at 40-41 (recommending that cash liquidating distributions in termination of a partner's interest be treated as a sale of a partnership interest under a "full-fragmentation" approach).
205. Id. at 40-41.
206. Id. at 23. See also id. at 51-55.
207. Id. at 23.
208. Id. at 66 (repeal of most of section 736, with exception for payments to general partners in partnerships in which capital is not a material income-producing factor).
209. Postlewaite, supra note 8, at 614-15 (outright repeal of section 736, with special provision for payments from a legitimate retirement benefit fund).
capital gain under section 736(b) or as ordinary income under section 736(a).\textsuperscript{210} If the parties agree to section 736(a) treatment, the payments are deductible by the partnership under section 162(a) and excluded from the other partners' distributive share of partnership income. Prior to the 1986 Act, the advantage of an immediate deduction to the partnership for goodwill payments was at least offset by ordinary income treatment to the retiring partner. Both the partnership and the distributee partner could generally improve their after-tax positions, however, if the distributee agreed to treat the goodwill payments under section 736(a) as ordinary income in exchange for a larger payment.\textsuperscript{211} The 1986 Act has exacerbated this problem by the repeal of preferential treatment for capital gains.

Although complete liquidations and sales of partnership interests would generally be subject to the full-fragmentation approach, the ALI proposals would continue to preserve nonrecognition treatment for non-liquidating distributions and liquidating distributions of non-cash property.\textsuperscript{212} Nonrecognition treatment of current distributions which do not alter the partners' interests in the partnership should generally be retained. The rationale for granting nonrecognition treatment to current distributions is that such distributions represent merely the receipt of partnership earnings previously taxed to the partners as a portion of their distributive share of partnership profits or a return of the partner's capital.\textsuperscript{213} This rationale, however, cannot serve to justify nonrecognition treatment of non-pro rata distributions which reflect a shift in the partners' interests in the partnership. Deferral of gain or loss inherent in the distributee's share of partnership assets should not be permitted for a non-pro rata distribution, since the distributee has effectively terminated his interest in a portion of the partnership's underlying assets and should be taxed accordingly.\textsuperscript{214}

Despite the theoretical justification for treating complete liquidations and non-pro rata distributions alike, the ALI rejected the full-fragmentation approach for non-pro rata distributions. This decision was most likely influenced by a desire to avoid additional complexity that would result from the application of the full-fragmentation approach when the distributee partner retains a reduced interest in the partnership. If a partner's interest in the partnership is only partially terminated, severe computational problems may arise in determining the portion of the interest which has been relinquished. These problems are exacerbated in partnerships using complex profit and loss sharing ratios, although the valuation rules are identical.\textsuperscript{215} This is

\textsuperscript{210} ALI Tax Project, supra note 6, at 59-62.
\textsuperscript{211} See W. McKee, supra note 16, \S 22.04[4].
\textsuperscript{212} ALI Tax Project, supra note 6, at 31-36.
\textsuperscript{213} See Postlewaite, supra note 8, at 597.
\textsuperscript{214} See supra note 197 and accompanying text.
\textsuperscript{215} See ALI Tax Project, supra note 6, at 44 (computation of partner's proportionate interest).
because the full-fragmentation approach to partial liquidations requires a comparison of the distributee's pro rata interest in the individual partnership assets immediately prior to the distribution, with the distributee's retained pro rata interest in the individual partnership assets immediately after the distribution. These computational problems are essentially analogous to those arising under the present collapsible partnership rules of section 751 when there is a shift in the partners' interests in ordinary income and capital gain assets.216

The ALI's distribution proposals, however, were premised on the existence of a "simpler" model of partnership taxation in which the complexities of present section 704(c) and the final section 704(b) regulations were not operative. Under the present regime, more thoroughgoing reform of the distribution rules should not be rejected solely on grounds of additional complexity. Under section 704(b), partnership assets must generally be re-valued whenever a liquidating or a non-liquidating distribution occurs, and the partners' interests in the partnership must be redetermined to reflect accurately the effect of a distribution on capital accounts.217 Indeed, the final section 704(b) regulations warn that a failure to restate capital accounts to reflect the fair market value of partnership assets, or to achieve a similar result through special allocation of gain or loss upon the acquisition or relinquishment of a partnership interest, may have substantial adverse consequences.218

Given the present framework of section 704(c) and the section 704(b) regulations, the ALI's decision to preserve the existing distribution rules for non-pro rata distributions deserves critical re-examination, as does the ALI's rejection of the deferred sale approach on grounds of additional complexity and valuation difficulties. Since the valuation problems are already present under the final section 704(b) regulations, what was once viewed as a source of additional complexity may now be perceived as an opportunity to rationalize Subchapter K. The issue is undoubtedly a difficult one, and should perhaps be resolved on grounds of practicality rather than mere theoretical consistency. If the present distribution rules are a source of potential abuse, as seems likely, more thoroughgoing rationalization should be pursued, especially if this can be achieved without adding appreciably to existing complexities.

This Article's proposed distribution rules would require line-drawing between non-pro rata distributions which result in a shift in the partners' interests in the partnership and a series of non-pro rata distributions which in the aggregate leave the partners' interests in the partnership unchanged.219

216. See W. McKee, supra note 16, ¶ 16.02.
219. See Postlewaite, supra note 8, at 606.
Although such line-drawing would impose some additional complexity, administratively workable solutions are feasible. If a series of non-pro rata distributions yields a result that is pro rata in the aggregate, nonrecognition treatment should generally be available under the rule for current distributions. An administrative rule might provide that current distribution treatment applies to a series of non-pro rata distributions only to the extent that the partners have received an equivalent amount of partnership property by the end of the partnership's taxable year or within a short period thereafter. Any excess portion of the distribution would be treated as a partial liquidation of the non-pro rata recipient's partnership interest, subject to recognition of gain or loss.

CONCLUSION

In enacting the disguised sale provisions, Congress sought to prevent taxpayers from treating transactions which closely resemble sales of property or partnership interests as tax-free contributions-distributions. Recently, one commentator has suggested that the Committee Reports on the disguised sale provisions of the 1984 Act are "masterpieces of dissimulation and vagueness," based on the argument that the distinction between sales and contributions is "illusory." This Article has criticized the 1984 Act provisions on quite different conceptual grounds.

First, the Article has set forth possible regulatory approaches consistent with the anti-abuse purpose of the disguised sale provisions and Congress' underlying assumption that the sale-contribution dichotomy represents substantive economic differences. The essence of the economic distinction between a contribution and a sale is whether the contributing partner bears a material entrepreneurial risk of nonpayment or whether the other partners are, in effect, guaranteeing payment to the contributing partner for the contributed property. Congress granted broad regulatory authority to the Treasury in implementing section 707 to ensure that tax consequences should generally follow these economic distinctions.

Second, the Article has indicated that the classification issues are conceptually difficult because the disguised sale provisions do not necessarily mesh well with the general provisions of Subchapter K which Congress did not intend to alter. Because the section 707 regulations may suffer from infirmities similar to those of the abortive section 385 regulations, the Article has explored alternative approaches to organizational transfers. These alter-

220. Id.
221. Id. at 609-10.
222. Id. at 609-10.
223. See Keyser, supra note 8, at 277.
224. Id. at 270. See also supra note 163 and accompanying text.
native approaches are premised on the assumption that policy considerations may justify immediate or deferred sale treatment of organizational transfers in the interest of simplification and rationalization of Subchapter K.

Third, the Article has advocated that a deferred sale approach be implemented in conjunction with proposed reforms in the distribution rules of Subchapter K. The reasons for linking the two proposals are twofold. On the one hand, unless the distribution proposals for liquidating and non-pro rata distributions are adopted, the deferred sale approach cannot offer a fully effective cure for existing abuses such as the disguised sale problem. On the other hand, the distribution proposals can operate effectively and simply only if the deferred sale approach to formation and post-formation transfers is adopted. Stated differently, the disguised sale problem is both a contribution and a distribution problem that can be fully resolved only through application of analytically consistent rules that address both the contribution and distribution ends of the spectrum.

The underlying approach to contribution-distribution problems set forth in this Article reflects a blend of entity and aggregate principles. This approach is consistent with the ALI's fundamental assumption that the ideal partnership model should conform as nearly as possible to pure aggregate principles, in the absence of countervailing factors. The Article's proposals build upon the analytical framework of the ALI's project on Subchapter K, but are also strongly influenced by the recent comprehensive critique of the ALI's study. Although that critique would adopt an entity-based immediate sale approach to organizational transfers, this Article has concluded that a deferred sale approach can reach substantially identical results. This conclusion rests on the premise that the deferred sale approach is essentially identical to an immediate sale approach, except that it avoids the deterrent effect on partnership formation and post-formation transfers.

Despite their differing conceptual premises, the underlying goal of both the immediate sale and deferred sale approaches are substantially identical: Both seek simplification and rationalization of Subchapter K. The case for abandoning or modifying the aggregate model in future reform of Subchapter K must be made in light of what the aggregate model can or cannot accomplish, consistent with these goals. Ultimately, the choice between the deferred sale and immediate sale approach may rest largely upon perceptions concerning the ideal model of partnership taxation.