

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-146917-02

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

TP =

X =

Y =

Z1 =

Z2 =

Z3 =

PRS =

Business =

Year 1 =

D1 =
D2 =
D3 =
D4 =
D5 =
D6 =
D7 =
a% =
b% =
c% =
d% =
e% =
f% =
g% =
h% =
i% =
j% =
k% =
\$a =
\$b =
\$c =
\$d =
\$e =

\$f =

\$g =

\$h =

#a =

ISSUE:

Whether the transactions are properly characterized as a disguised sale of a partnership interest?

CONCLUSION:

The transactions are properly characterized as a disguised sale of a partnership interest.

FACTS:

In Year 1, TP and X considered the formation of a new Business. Although X did not invest in the venture at that time, the parties considered the possibility that X would invest in the Business in the future. Accordingly, on D1, TP and X executed an Option Agreement that gave X the right to a future investment in the Business.

On D3, TP, through its affiliates, Z1 and Z2, formed PRS, a general partnership. Z1 contributed cash for a b% interest in PRS, and Z2, contributed cash for a j% interest in PRS. On D4, PRS's partnership agreement was amended, and Z3, an affiliate of TP, was admitted as a partner. At that time, Z1 owned a a% interest in PRS, Z2 owned a f% interest in PRS, and Z3 owned a g% interest in PRS. TP, through its affiliates, owned and funded PRS from D2 through D5.

The Option Agreement granted X, through its affiliate, Y, and other authorized affiliates (hereinafter "Y"), an option to invest in PRS. The Option Agreement specifically provided that Y had the right to acquire an equity interest in PRS equal to and of the same class as the equity interest owned by TP. The Option agreement required that Y provide formal notice to TP that it was going to exercise the option at least #a days prior to the exercise date of the option. Y also was required to tender, by the exercise date, the amount it needed to invest in order to acquire a g% interest in PRS.

The parties calculated Y's required contribution to PRS based upon the amount of TP's prior contributions to PRS. The Option Agreement provided for an Investment Amount, which equaled TP's prior cash contributions to PRS (either by contributions of capital or by assumption of indebtedness) through the exercise date of the option, less cash or

property distributions to TP prior to the exercise date, plus any other cash contributed to PRS, plus interest. This calculation was intended to be cost based and equalize the investments made by TP and Y in PRS. As of D6, the Investment Amount was \$h.

If Y chose to exercise its option, TP could elect one of three alternatives by which Y would acquire a g% interest in PRS. Under the first alternative, Y was required to contribute the full Investment Amount to PRS. PRS was required to retain d% of the Investment Amount, and equally distribute i% (e% each) to TP and Y. Under the second alternative, if the Investment Amount exceeded \$c, Y was required to contribute h% of the investment Amount to PRS. PRS was required to distribute e% of the Investment Amount to TP. Under both of these alternatives, TP and Y each would have an investment in PRS equal to h% of the Investment Amount. Under the third alternative, Y was required to purchase a portion of TP's partnership interest in PRS.

Y timely provided notice to TP that it intended to exercise its option. TP elected to have Y exercise the option under the second alternative. Accordingly, on D7, Y exercised the option, and acquired a g% interest PRS. Y was required to contribute \$g (h% of the Investment Amount) to PRS. This figure was computed by adding g% of the Investment Amount (\$f) and c% of the Investment Amount (\$a). In accordance with the capital account maintenance rules of § 1.704-1(b)(2)(iv)(b), all of the cash contributed by Y was credited to Y's capital account. On or about D7, PRS distributed \$e (e% of the Investment Amount) to TP. TP's basis in its PRS interest equaled \$b. Accordingly, TP reported a gain of \$d on the distribution.

LAW AND ANALYSIS:

Section 707 and its Legislative History

Section 707(a)(2)(B) of the Code provides that if (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as occurring between the partnership and one who is not a partner, or as a transaction between two or more partners acting other than in their capacity as members of the partnership.

The legislative history of § 707(a)(2)(B) indicates that the provision was adopted as a result of Congress' concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by a related partnership distribution. See S. Prt. No. 169, (Vol. I), 98th Cong., 2d Sess. 225 (1984)(hereinafter "S. Prt."); H.R. Rep. No. 432, (Pt. 2) 98th Cong., 2d Sess. 1218 (1984) (hereinafter "H.R. Rep."). Specifically, Congress was concerned about court

decisions that allowed tax-free treatment in cases which were economically indistinguishable from sales of property to a partnership or another partner. See S. Prt. at 225; H.R. Rep. at 1218 (discussing *Jupiter Corp. v. United States*, No. 83-842 (Ct. Cl. 1983) and *Communications Satellite Corp. V. United States*, 223 Ct. Cl 253 (1980) both of which involved the disguised sale of a partnership interest). Congress believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. See S. Prt. at 225; H.R. Rep. at 1218.

In the legislative history of § 707(a)(2)(B), Congress explained that pursuant to § 721, gain or loss generally is not recognized on the contribution of property to a partnership in return for a partnership interest, and pursuant to § 731 distributions of money from a partnership to a partner are generally tax-free to the extent of the adjusted basis of the recipient partner's interest in the partnership. See S. Prt. at 224; H.R. Rep. at 1217. Congress referred to Treasury regulations issued under §§ 721 and 731 in its discussion of disguised sales. See S. Prt. at 224; H.R. Rep. at 1217. The § 721 regulations provide that, if the transfer of property by a partner to a partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange rather than a contribution (Treas. Reg. sec. 1.721-1(a)). See S. Prt. at 224; H.R. Rep. at 1217. These regulations require that the substance of the transaction, rather than its form, will govern in such cases. See S. Prt. at 224; H.R. Rep. at 1217. The regulations issued under § 731 provide that if a contribution of property is made to a partnership and (1) within a short time before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or (2) within a short time after such contribution to the partnership, contributed property is distributed to another partner, tax free distribution treatment may not apply (Treas. Reg. sec. 1.731-1(c)(3)). See S. Prt. at 225; H.R. Rep. at 1217-1218. The regulations deny tax-free treatment if a purported distribution was, in fact, made to effect an exchange of property between two or more of the partners or between the partnership and a partner. See S. Prt. at 224-225; H.R. Rep. at 1217-1218.

Congress expressed its concern that the regulations issued under §§ 721 and 731 may not always prevent de facto sales of property to a partnership or another partner from being structured as a contribution to the partnership, followed or preceded by a tax-free distribution from the partnership. See S. Prt. a 225; H.R. Rep. at 1218. Congress specifically discussed case law that permitted results which were economically indistinguishable from a sale of all or part of the property despite the regulations described above and enacted § 707(a)(2)(B) to expressly prohibit such transactions. See *Jupiter Corp. v. United States*, No. 83-842 (Ct. Cl. 1983); *Communications Satellite Corp. v. United States*, 223 Ct. Cl. 253 (1980); S. Prt. at 225; H.R. Rep. at 1218.

Analysis

Section 707(a)(2)(B) lists three elements that must be satisfied to recharacterize property transfers to and from a partnership as a transaction between two or more partners acting other than in their capacity as members of the partnership. First, there must be a direct or indirect transfer of money or other property by a partner to a partnership. On or about D7, Y directly transferred \$g (h% of the Investment Amount) to PRS. Second, it must be shown that there is a related direct or indirect transfer of money or other property by the partnership to such partner. After Y timely provided notice to TP that it intended to exercise its option, TP elected to have Y exercise the option under the second alternative. Under the second alternative, Y was required to transfer \$g (h% of the Investment Amount) to PRS, and PRS was required to transfer \$e (e% of the Investment Amount) to TP. The Option Agreement provided for and required related transfers between Y and PRS, and PRS and TP. The transfer by PRS to TP, would not have occurred but for the transfer from Y to PRS. Accordingly, the first and second elements enumerated in § 707(a)(2)(B) are satisfied in this case.

Third, the transfers described in the previous paragraph, when viewed together, must be properly characterized as a sale. Therefore, to satisfy the third requirement of § 707(a)(2)(B) it must be shown that the related transfers to and from PRS were in substance a sale or exchange of PRS partnership interests between Y and TP. Prior to Y's exercise of its option, TP owned k% of PRS. Upon Y's contribution of \$g to PRS, TP's partnership interest in PRS was reduced as a result of the infusion of new capital into PRS. The related distribution of \$e, which represented e% of the Investment Amount, to TP reduced TP's interest in PRS by approximately e% of its equity interest in PRS. As a result, there was an equity shift in PRS from TP to Y. The equity shift was in substance a sale by TP to PRS of approximately e% of its partnership interest in PRS for which TP received an amount realized of \$e. Accordingly, all of the elements enumerated in § 707(a)(2)(B) are satisfied in this case.

The similarities between this case and _____, a case Congress cited as a cause for concern when it enacted § 707(a)(2)(B), reinforces our conclusion that the transfers were in substance a sale by TP to PRS of approximately e% of its partnership interest in PRS. In _____, the taxpayer was a member of _____, a partnership formed under the auspices of the United Nations to operate a communications satellite system. Interests in _____ were originally available to specific parties, including the taxpayer. Each initial member in _____ received a percentage interest, called a quota, in the partnership. Members of the _____ also were entitled to join _____ on the same basis as the original members. Upon admission, new members were assigned a quota, and were required to contribute what would have been the member's pro rata share of capital contributions according to a specific formula. The effect of the formula was to place each new partner in essentially the same position with respect to capital contributions and profits distributions as if it had been a member from the beginning.

The Service argued that the admission of six new members into the partnership, and the subsequent distributions of cash to the taxpayer to reflect the taxpayer's reduced quota were a sale of a portion of the existing members' interests to the new members. The Court held that the substance of the transaction was a distribution of partnership property to the existing partners, rather than a sale of a partnership interest. In reaching its decision, the Court emphasized the unique character of _____ as an arrangement promoting international comity and cooperation. 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.

This case and _____ are similar in several respects. In _____ Communications Satellite, the parties understood from the formation of _____ that members of the _____ were entitled to join the partnership at a later date. In this case, Y and TP agreed, prior to the formation of PRS, that Y had the right to exercise its option and become a member of PRS at a later date. In _____, it was understood that new members would be treated as if they had been a member of _____ from its formation. In this case, the parties agreed that Y would be treated as if it had been a member of PRS from its formation. In _____, the 6 incoming partners' required contributions were calculated with a formula designed to be the member's pro rata share of capital contributions and profit distributions from _____ formation. In this case, Y was required to contribute an amount to PRS based upon a formula that was designed to treat Y as if it had been a member in PRS since PRS's formation. In both cases, after the new partners made their contribution, the partnership was required to make a related distribution to an existing partner. The related contributions and distributions in this case and _____, permit a result that is economically indistinguishable from a sale. See S. Prt. at 225; H.R. Rep. at 1218 (Congress specifically discussed _____ as case law that permitted results which were economically indistinguishable from a sale of all or part of the property despite the regulations described above and enacted § 707(a)(2)(B) to expressly prohibit such transactions).

The Absence of Regulations Regarding Disguised Sales of Partnership Interests

Although the Service has not promulgated regulations for disguised sales of partnership interests under § 707(a)(2)(B) (Income Tax Regulation § 1.707-7 is reserved), it may enforce § 707(a)(2)(B) in the context of a disguised sale of a partnership interest in the absence of regulations.

) (although the statute provided "to the extent provided in regulations" the plain language of the statute directs a single conclusion);

(regulations contemplated under § 2663(2) is not a necessary precondition to the imposition of the generation-skipping transfer tax on transfers involved in the case);

Rev. Rul. 91-47 (Service enforced § 108(e)(4), which applies “to the extent provided in regulations” before the regulations were issued). Prior to the issuance of the regulations, the determination of whether a transaction is a disguised sale of a partnership interest under § 707(a)(2)(B) is to be made on the basis of the statute and its legislative history. See Notice 2001-64, 2001-41 I.R.B. The plain language of the statute, as confirmed by the legislative history, imposes liability on the taxpayer in this case.

Conclusion

Based on the above, we conclude that the transactions were a disguised sale of a partnership interest between TP and X, through X’s affiliate, Y.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) provides that it may not be used or cited as precedent.