PARTNERSHIP TAX AND DISGUISED SALES §704(c)(1)B

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There are several disguised sale rules under Subchapter K. IRC Sections 707(a)(2)(B), 704(c)(1)(B), 737 and 751(b). Needless to say, Congress has created an extremely complicated set of rules, many of which are traps for the unwary.

Two of these sections have a lot of subtleties built in and are probably violated often unintentionally. These are 704(c)(1)(B) and 737 which purportedly are supposed to act in tandem. The first deals with the situation where a partner who contributes built in gain property must recognize gain when that same property is distributed to another partner. The objective of this section is to prevent the contributing partner from shifting that built in gain to another partner. The second deals with the situation where a partner contributes built in gain property and then receives other property as a distribution. The purported purpose of this section is to prevent the contributing partner from avoiding the built in gain by receiving an in kind distribution in partial or complete liquidation of his interest.

Both of these sections often apply in novel and unexpected situations. Below you will find a detailed explanation of the operation of 704(c)(1)(B). In our next newsletter we will address 737.

Partnership Tax and Disguised Sales §704(c)(1)B

Prior Law

• As originally enacted, IRC Section 704(c)(1)(A), a partner contributing property with a built-in-gain or loss to a partnership is generally allocated that gain or loss when the partnership subsequently disposes of the property.
• Prior to the enactment of IRC Section 704(c)(1)(B), a contributing partner could avoid an allocation of precontribution gain or loss if the partnership distributed the contributed property to another partner rather than selling it.

Example 1 - Facts:
• A contributes Blackacre with an adjusted basis of $12,000 and a fair market value of $20,000.
• B contributes $20,000 cash.
• Three years later the partnership distributes Blackacre, then worth $23,000, to B.

Example 1 - Tax:
• Before Section 704(c)(1)(B), Blackacre could be distributed to B without any gain recognized to A.
• A's outside basis would remain at $12,000.
Blackacre's basis in B's hands would stay at $12,000.

Current Law

- If property contributed by one partner has built-in gain and if that property is distributed to another partner within 7 years of its contribution to the partnership, the contributing partner (or his successor) is treated as recognizing Section 704(c) built-in gain or loss as if the partnership had sold the property for its fair market value at the time of the distribution.
- The contributing partner's outside basis is increased or decreased by the amount of gain or loss recognized as a result of the distribution.
- To avoid double recognition of that gain or loss, the partnership's inside basis in the property is increased or decreased PRIOR to the distribution to reflect the gain or loss recognized by the contributing partner.
- The recognition rules apply to contributing partners and their successors. Thus, if a contributing partner transfers a partnership interest, following which the partnership distributes the contributed property to a partner other than the transferee, the transferee recognizes gain in the same manner and amount that would have been allocable to the original contributor (Code §704(c)(3)).

Recognition of Gain and Basis Adjustment Under §704(c)(1)(B)

Example 2 - Facts:
- A contributes Blackacre with an adjusted basis of $12,000 and a fair market value of $20,000
- B contributes $20,000 cash.
- Three years later the partnership distributes Blackacre, then worth $23,000, to B.

Example 2 - Tax:
- Under Section 704(c)(1)(B), A is allocated the $8,000 precontribution gain just as if the partnership had sold the property instead of distributing it.
- A would increase his outside basis by $8,000 to $20,000.
- Blackacre's basis would be $20,000.

Character of Gain or Loss: Capital or Ordinary

Rule:
- The character of this gain or loss is determined as if the partnership sold the property to the distributee.
- This means that ordinarily the character of the gain or loss will be determined by the character of the property in the hands of the partnership.
- Recharacterization rules may apply, however, such as IRC §707(b)(2) to convert capital gain to ordinary income.

Example 3 - Facts:
A and B form partnership AB. A contributes $10,000 cash and Blackacre (nondepreciable real property) with a FMV of $10,000 and an adjusted tax basis of $4,000, in exchange for a 25% interest in AB.

B contributes $60,000 cash for a 75% interest.

Three years later, Blackacre is distributed to B in a current distribution. Blackacre is used in a trade or business of B.

**Example 3 - Tax:**

- A would have recognized $6,000 of gain on a sale of Blackacre at the time of the distribution (i.e., FMV of $10,000 less adjusted basis of $4,000).
- Because Blackacre is not a capital asset in the hands of Partner B and B holds more than 50% interest, the character of the gain on a sale of Blackacre to B would have been ordinary income under section 707(b)(2).
- Thus, the character of the gain to A on the distribution of Blackacre to B is ordinary income.

**Effect of Post-Contribution Depreciation on Built-In Gain**

**Rule:**

- Post-contribution depreciation deductions will reduce the amount of built-in-gain.

**Example 4 - Facts:**

- A, B and C form partnership ABC as equal partners. A contributes Property A, depreciable property with a fair market value of $30,000 and an adjusted tax basis of $20,000.
- B and C each contribute $30,000 cash.
- ABC uses the traditional method of making section 704(c) allocations described in §1.704-3(b) with respect to Property A.
- Property A is depreciated using the straight-line method over its remaining 10-year recovery period.
- The partnership has book Depreciation of $3,000 per year (10 percent of the $30,000 book basis), and each partner is allocated $1,000 of book depreciation per year (one-third of the total annual book depreciation of $3,000).
- The partnership has a tax depreciation deduction of $2,000 per year (10 percent of the $20,000 tax basis in Property A).
- This $2,000 tax depreciation deduction with respect to Property A is allocated equally between B and C, the noncontributing partners, and none to A.

**Example 4 - Facts:**

- At the end of the third year, the book value of property A is $21,000 ($30,000 initial book value less $9,000 aggregate book depreciation) and the adjusted tax basis is $14,000 ($20,000 initial tax basis less $6,000 aggregate tax depreciation).
- A's remaining section 704(c)(1)(A) built-in gain with respect to Property A is $7,000 ($21,000 book value less $14,000 adjusted tax basis).
- Three years after formation, Property A is distributed to B in complete liquidation of B’s interest in the partnership.
• If Property A had been sold for its fair market value at the time of the distribution, A would have recognized $7,000 of gain under §704(c)(1)(A) and §1.704-3(b). Therefore, A recognizes $7,000 of gain on the distribution of Property A to B.

**Example 4 - Tax:**
• If Property A had been sold for its fair market value at the time of the distribution, A would have recognized $7,000 of gain under §704(c)(1)(A) and §1.704-3(b).
• Therefore, A recognizes $7,000 of gain on the distribution of Property A to B.

**Exceptions**

**Property Distributed to Contributing Partner**
• Section 704(c)(1)(B) does not apply if the contributed property is distributed back to the contributing partner.

**Example 5:**
• A contributes Blackacre with an adjusted basis of $12,000 and a FMV of $20,000.
• B contributes $20,000 cash to the equal AB partnership.
• Three years later, the partnership distributes Blackacre, then worth $23,000, back to A.
• Since A is the contributing partner, Section 704(c)(1)(B) does not apply.

**Distributions that Would Otherwise Qualify for Like-Kind Treatment**
• Section 704(c)(2) provides relief to a contributing partner who receives a distribution of like-kind property (within the meaning of Section 1031) within 180 days after the contributed property is distributed to another partner.
• The policy is that the contributing partner should not have to recognize gain under Section 704(c)(1)(B) if he would have qualified for nonrecognition if the transaction had taken place outside the partnership.

**Example 6 - Facts:**
• A, B, and C form partnership ABC as equal partners.
• A contributes Property X (nondepreciable real property) with a FMV of $20,000 and an adjusted tax basis of $10,000.
• B and C each contribute $20,000 cash.
• ABC subsequently buys Property Y, nondepreciable real property of a like-kind property to X with a FMV and adjusted tax basis of $8,000.
• The FMV of Property Y subsequently increases to $10,000.

**Example 6 - Facts:**
• Three years later, Property X is distributed to B in a current distribution.
• At the same time, Property Y is distributed to A in a current distribution.
• A's basis in Y is $8,000 under §732(a)(1)
Example 6 - Tax:
- A has $2,000 of built-in gain in Y ($10,000 fair market value less $8,000 adjusted tax basis).
- A would generally recognize $10,000 of gain on the distribution of Property X to B (i.e., FMV of $20,000 less the $10,000 basis).
- This gain is reduced, however, by the amount of the built-in gain of Property Y in the hands of A.
- As a result, A recognizes only $8,000 of gain on the distribution of Property X to B.

Other Exceptions

Distributions of Contributed Property will Not Trigger Gain or Loss in the Case of:
- Contributions before effective date. Property contributed on or before October 3, 1989 (Reg. §1.704-4(c)(1)).
- Certain liquidations. A distribution of an interest in contributed property to a partner in liquidation of the partnership if (1) the contributing partner receives an interest in the contributed property (and no other property) and (2) the built-in gain or loss in the interest distributed to the contributing partner is equal to or greater than the built-in gain or loss that would have been allocated to that partner on a sale of the property immediately before the distribution (Reg. §1.704-4(c)(2)).
- Termination. A deemed distribution caused by a termination of the partnership under Code §708(b)(1)(B) (Reg. §1.704-4(c)(3)).
- Tiered partnership transaction. A partnership that transfers all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described by Code §721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement (Reg. §1.704-4(c)(4)).
- Incorporation. Incorporation of a partnership, provided that the partnership is liquidated as part of the incorporation transaction (Reg. §1.704-4(c)(5)). However, if the partnership distributes its property to the partners, following which that property is contributed to a corporation, this exception does not apply.
- Undivided Interests. Distribution of an undivided interest in property, to the extent that the undivided interest does not exceed the undivided interests, if any, contributed by the distributing partner in the same property (Regs. §1.704-4(c)(6)).

Anti-Abuse
- The regulations under Section 704(c)(1)(B) also contain an anti-abuse provision under which the statute and regulations must be applied in a manner consistent with the purpose of the section, or the Service can recast a transaction for federal tax purposes to achieve appropriate tax results.
- For example, the regulations apply Section 704(c)(1)(B) to a distribution that actually takes place after the statute’s time limitation (i.e., more than seven years after the contribution of property), but where the partners took steps that were the functional equivalent of a distribution before the end of that period.

Example 7 - Facts:
A, B, and C form partnership ABC as equal partners.
A contributes Property X (nondepreciable real property) with a FMV $10,000 and an adjusted tax basis of $1,000.
B and C each contributes $10,000 cash.
Three years later, the partners desire to distribute Property X to B in complete liquidation of B's interest in the partnership.
If Property X were distributed at that time, however, A would recognize $9,000 of gain under section 704(c)(1)(B).
On becoming aware of this potential gain recognition, the partners amend the partnership agreement to avoid the gain.
As a result, substantially all of the economic risks and benefits of Property X are borne by B
Substantially all of the economic risks and benefits of all other partnership property are borne by A and C.
The partnership holds Property X until 7 years has lapsed, and then distributes it to B in liquidation of B's interest.

Example 7 - Tax:
The tax-avoidance steps taken by the partnership are the functional equivalent of an actual distribution of Property X to B in complete liquidation of B's interest in the partnership as of that date.
Section 704(c)(1)(B) requires the recognition of gain when contributed section 704(c) property is in substance distributed to another partner within 7 years of its contribution to the partnership.
Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as this would effectively undermine the purpose of section 704(c)(1)(B).
As a result, the steps taken by the partnership are treated as causing a distribution of X to B on the date the partnership agreement was amended.
A recognizes gain of $9,000 at that time.

Example 7 Alternative:
Alternatively, if the partners had instead agreed that B would continue as a partner with no changes to the partnership agreement or to B's economic interest in partnership operations, the distribution of Property X to B would not have been inconsistent with the purpose of section 704(c)(1)(B).
In that situation, Property X would not have been distributed until after the expiration of the 7-year period.
Deferring the distribution of Property X until the end of the 7-year period for a principal purpose of avoiding the recognition of gain under section 704(c)(1)(B) is not inconsistent with the purpose of that section.
Therefore, A would not have recognized gain on the distribution of Property X in that case.