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Can the IRS Currently Contend That There Has Been a Disguised Sale of a Partnership Interest?

In this column, Samuel Grilli of Baker & McKenzie analyzes whether the IRS has the authority now to determine that a contribution of cash to a partnership and a related distribution to another partner gives rise to a disguised sale of a partnership interest.

Proximate Contributions to and Distributions from a Partnership. Contributions to and distributions from a partnership are generally tax-free transactions for federal tax purposes (subject to numerous exceptions, of course). This is a fundamental feature of the nature of a partnership and goes to the essence of the taxation of partnerships. In the early 1980s, Congress developed anxiety that sales of partnership interests, which are taxable transactions, were instead being structured as related contributions and distributions that roughly accomplished the same economic transaction, but in a tax-free manner.

To alleviate this anxiety, Congress revised Section 707(a)(2)(B), which basically tasked the IRS with figuring out how to craft workable rules that distinguish such related contributions and distributions from all of the other numerous non-abusive and ordinary course of business contributions and distributions. The IRS has been unable to figure out how to do this even though it has had a long time to try (i.e. decades!).

We regularly receive calls from clients asking about contemplated contributions and distributions that will be proximate in time or otherwise related in some way. There is legitimate concern that the IRS will claim that such proximate nontaxable contributions and distributions should instead be recharacterized and treated as taxable sales of partnership interests. On what legal basis can the IRS currently make this claim, however?

Background of the Disguised Sale Rules. Although the regulations under Subchapter K of the Code dealing with the U.S. federal income tax treatment of partnerships had already provided that the substance of the transaction should govern, Congress came to fear that courts would allow tax-free treatment in cases that Congress viewed as economically indistinguishable from sales—specifically citing *Otey*, 70 TC 312 (1978), aff'd per curiam 634 F.2d 1046, 47 AFTR2d 81-301 (CA-6, 1980). *Communications Satellite Corp.*, 625 F.2d 997, 45 AFTR2d 80-1189 (Ct. Cl., 1980), and *Jupiter Corp.*, 51 AFTR2d 83-823 (Cls. Ct., 1983).

Otey did not concern the issue of disguised sales of partnership interests. The question in the case was whether there had been a disguised sale of property. In *Otey*, the Tax Court found that the taxpayer's transfer of real property to a partnership followed by a distribution of loan proceeds to him by the partnership was a contribution to capital and not a sale, because the taxpayer wasn't guaranteed payment by the partnership and such a pattern of transactions was normal and standard for partnership capitalization.

The relevant case law on disguised sales of partnership interests essentially comprises the other two cases cited by Congress, *Communications Satellite* and *Jupiter*, both of which involve partnership cash distributions to one or more partners of consideration that could be traced directly to cash contributions made by another partner. In both of these cases, the Court of Claims held that the payments to the partners were partnership distributions and not proceeds from the sale of partnership interests. As a result of these cases, Congress became anxious that taxpayers were escaping tax on sales of property (including partnership interests) by characterizing sales as contributions of property, including money, followed or preceded by a related partnership distribution.

Communications Satellite Corp. In *Communications Satellite*, the tax-

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payer was a member of an international joint venture that operated a global commercial communications satellite system pursuant to a U.N. directive. The taxpayer had made an initial capital contribution to the joint venture. When six countries were admitted to the joint venture several years later, the taxpayer received a distribution from the joint venture that was traceable to the funds contributed by the new members. The IRS argued that the substance of this transaction was a sale of an interest in the joint venture by the taxpayer to the new members. The Court of Claims, however, emphasized that there were no negotiations between the incoming partners and the taxpayer, and there were no contracts of sale between the old and new partners. The entry fees that the new partners paid to join the system had no relationship to the actual value of their interests in the joint venture. All the facts simply indicated that the transaction constituted a capital contribution by the new partners and a nontaxable distribution to the old partners.

> **Unless and until the IRS can figure out how to implement this provision in regulations, the IRS has a weak legal basis, if any, to claim a disguised sale of a partnership interest under Section 707(a)(2)(B).**

Jupiter Corp. In *Jupiter*, the taxpayer owned a 77.5% general partnership interest in a limited partnership formed to construct a real estate project, and an unrelated party, Empire, owned the remaining 22.5% interest as a limited partner. The partnership obtained a $20 million mortgage loan, and under the original partnership agreement, the taxpayer was obligated to supply all additional funds needed to complete construction. The taxpayer loaned the partnership approximately $4 million. After completion of construction, new investors were sought. The taxpayer initially planned to proportionately reduce its interest and Empire's interest in the partnership to allow the admission of the Wilkow Group, but Empire refused to consent if the result was a reduction in its proportional partnership interest. The parties therefore structured the reorganization of the partnership so that the taxpayer's interest was decreased from 77.5% to 57.5% upon the admission of the Wilkow Group as a limited partner with a 20% interest and certain other concessions made to Empire. (The amended partnership agreement relieved Empire of any obligation to contribute capital to meet the monthly payments of the preferred return to the Wilkow Group; the taxpayer was required to loan Empire $500,000 which was to be repaid solely out of Empire's proceeds from the partnership.) The Wilkow Group contributed approximately $1.2 million to the capital of the partnership, on which it received a preferred return, and loaned $3.5 million to the partnership at an interest rate of 4%. The partnership repaid the taxpayer's outstanding loan to the partnership and the remainder of the amount that the Wilkow Group contributed and loaned to the partnership was distributed to Empire and to the taxpayer in proportion to their pre-reorganization partnership interests.

The IRS claimed that the cash was taxable as the proceeds of a sale of a portion of the taxpayer's partnership interest, whereas the taxpayer claimed that the money was a nontaxable distribution. The court concluded that the intent was unquestionably to reorganize the partnership and admit the Wilkow Group as a new limited partner, rather than to sell a portion of the taxpayer's general partnership interest. The Wilkow Group's limited partnership interest did not exist prior to the reorganization of the partnership. The newly-created limited partnership interest (1) gave the Wilkow Group cumulative rights to monthly distributions of income which had priority over all distributions to the other partners, and (ii) carried no obligation to advance money needed by the partnership beyond the initial capital contribution and loan. Since the Wilkow Group's limited partnership interest was unique from the partnership interests owned by the other partners, the court concluded that the Wilkow Group could not have purchased this interest directly from either party.

Moreover, although the taxpayer's general partnership interest was decreased from 77.5% to 57.5% after the reorganization, the court found that the taxpayer remained in a more favorable position after the reorganization than it would have if it had directly sold a 20% general partnership interest to the Wilkow Group, because, after the reorganization, the taxpayer remained the sole general partner with 100% control of the management of the partnership. Another indication that the transaction was intended, and could only have been accomplished, as a reorganization of the partnership was the change the amended partnership agreement made in the rights and obligations of the taxpayer and Empire vis-à-vis each other, which could not have been accomplished by a direct sale of a portion of the taxpayer's general partnership interest. Finally, the Wilkow Group's cash was distributed to the taxpayer and Empire according to their respective pre-reorganization partnership interests. If the taxpayer's intent was to sell a portion of its interest, it would have received 100% of the "purchase price" that the Wilkow Group paid for the interest. Consequently, the court concluded that there was not a disguised sale of a partnership interest.

Thereafter, as a result of concerns brought on by these cases, Congress

revised Section 707(a)(2)(B), which provides that under regulations prescribed by the Secretary, if (1) there is a direct or indirect transfer of money or other property by a partner to a partnership; (2) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner); and (3) the transfers described in clauses (1) and (2), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction between a partnership and a partner acting in a capacity other than as a partner or as a transaction between two or more partners acting other than in their capacity as partners.

The Failure and Retraction of the Proposed Regulations Pertaining to Disguised Sales of Partnership Interests. When the IRS initially issued regulations under Section 707 in 1992 (TD 8439 (as corrected on 11/30/92), those addressing disguised sales of partnership interests were reserved (Reg. 1.707-7). In Notice 2001-64, 2001-2 CB 316, the IRS announced that it was considering issuing proposed regulations relating to disguised sales of partnership interests and requested comments. On 11/26/04, the IRS issued proposed regulations under Section 707, including Prop. Reg. 1.707-7, addressing disguised sales of partnership interests (the Proposed Regulations). (REG-149519-03, 69 Fed. Reg. No. 227, p. 68838.) The Proposed Regulations were very controversial and were criticized as being flawed and overly broad, primarily because they could lead to absurd results.

In light of the severe criticism, the IRS officially withdrew the Proposed Regulations on 1/1/09 in Ann. 2009-4, 2009-8 IRB 597, stating that the IRS will continue to study this area and may issue guidance in the future. In withdrawing the Proposed Regulations, the IRS stated that, until new guidance is issued, any determination of whether a transfer between a partner or partners and a partnership is a transfer of a partnership interest will be based on statutory language, legislative history, and case law. After more than six and a half years, no new regulations on this issue have been proposed or finalized. Such a situation is referred to as a "spurned delegation," and there is a considerable body of case law addressing various types of spurned delegations and their implications.

Application of the Law of Spurned Delegations to Section 707(a)(2)(B). The absence of regulations generally is not a basis for thwarting the legislative objective or refusing to apply the substantive provisions of a Code section, especially so as not to deprive a taxpayer of congressionally intended rights. On the other hand, courts have addressed the different statutory language Congress has used to specially authorize regulations in the Code, and have recognized that certain statutory language conditions the effectiveness, or "self-executing" nature, of a Code provision on the issuance of regulations. Tax Court Judge Theodore Tannenwald, Jr. summarized the case law in this area in Estate of Neumann, 106 TC 216 (1996), wherein he imparted that "the teaching of the decided cases is that issuance of regulations is to be considered a precondition to the imposition of a tax where the applicable provision directing the issuance of such regulations reflects a 'whether' characterization, such as existed in [Alexander v. Commissioner], and not where the provision simply reflects a 'how' characterization."

If the IRS were to try to wield Section 707(a)(2)(B) in a court of law to claim a disguised sale of a partnership interest in the absence of regulations, might it find a highly critical judicial audience? In *First Chicago Corp.*, 842 F.2d 180, 61 AFTR2d 88-902 (CA-7, 1988), Judge Posner sharply remarked that: "It ill becomes the Treasury to complain that the Tax Court's method of adjustment...when the Treasury failed to prescribe its own method of adjustment though commanded by Congress to do so." It is very possible that a court would view it as an affront to the rule of law to apply such a statutory provision to a taxpayer in light of the decades-long failure of the IRS to put forward regulations on the matter, as instructed to do so by Congress.

In CCA 201009013, the IRS stated that "[t]here are no magic words in a statute which differentiate between a 'how' regulation and a 'whether' regulation." The IRS noted that often a "how" regulation provides that "the Secretary shall prescribe regulations" or "under regulations prescribed by the Secretary" whereas a "whether" regulation may provide "only to the extent provided in regulations." However, in the view of the IRS, neither phrase is determinative as to whether a statute is self-executing, and analysis of the legislative history is the only way to make such a determination. In CCA 201009013, the IRS addressed Section 336(e), which begins with "Under regulations prescribed by the Secretary" (the prefatory language of Section 707(a)(2)(B)) and which provides generally for an election by a corporation to treat certain dispositions of all of certain subsidiary stock as a disposition of such subsidiary's assets. Even though the IRS thought that the language "under regulations prescribed by the Secretary" was often indicative of a "how" regulation (i.e., a self-executing statute), the IRS nonetheless concluded that Section 336(e) was not self-executing.

This meant that, according to the IRS, there was no such thing as a Section 336(e) election prior to the promulgation of regulations authorizing such election. The IRS's basis for this conclusion was that the statute was extremely broad and its application too uncertain without final regulations. (The reasoning in this CCA also applies to Section 707(a)(2)(B) with respect to disguised sales of partnership interests, absent the issuance of applicable regulations.)

The Seventh Circuit's Applicable Warning to the IRS About Spurned Delegations. In *Pittway Corp.*, 102 F.3d 932, 78 AFTR2d 96-7616 (CA-7, 1996) the Seventh Circuit addressed Section 4662(b)(1) (providing for chemical excise taxes), which, like Section 707(a)(2)(B), is also prefaced with the language, "Under regulations prescribed by the Secretary." The court itself highlighted that the taxpayer's best argument was made only in pass-

ing: "that the [IRS] dropped the ball by never issuing regulations interpreting Section 4662(b)(1) even though the statute explicitly stated that such regulations were forthcoming." The IRS had failed to issue regulations for more than 15 years. The court sternly noted that while the government wanted the court to apply the plain meaning rule to the part of the statute imposing a chemical tax, it did not insist that the court read literally the prefatory words of the statute which began with "Under regulations prescribed by the Secretary." The court nonetheless ruled against the taxpayer because the court found the statutory language to direct a single clear conclusion on the facts presented. However, it expressly warned the IRS that "[i]n a statute less clear on its face, failure to promulgate regulations as Congress orders could result in a provision not enforceable due to the Secretary's failure."

The IRS cited *Pittway* in CCA 200250013 to support the IRS's position that although it had not promulgated regulations addressing disguised sales of partnership interests under Section 707(a)(2)(B), it could nonetheless enforce Section 707(a)(2)(B) in the absence of regulations. In citing *Pittway* as part of its support for this position, however, the IRS miscited the relevant language of the statutory provision at issue in *Pittway* as "to the extent provided in the regulations" (such language is generally viewed as indicative of a statutory provision that is not selfexecuting). Rather, the prefatory statutory language in *Pittway* was the same as that in Section 707(a)(2)(B): "Under regulations prescribed by the Secretary." *Pittway* is therefore better cited for the opposite position: that Section 707(a)(2)(B) is a statute that is not clear on its face, does not direct a single conclusion with respect to many fact patterns, and therefore, is not currently enforceable with respect to this issue due to the ongoing failure of the IRS to promulgate regulations.

The Proposed Regulations and the Implication of Their Retraction. The withdrawn Proposed Regulations addressed both whether certain transfers constituted disguised sales of partnership interests and also how to implement Section 707(a)(2)(B) in such case. The Proposed Regulations necessarily addressed the extent of the statute's application, identifying those transfers that should be subject to recharacterization under Section 707(a)(2)(B), because the statute has a significant "whether" aspect. This significant whether characterization of the statute, as demonstrated by the content of the withdrawn Proposed Regulations, supports the view that Section 707(a)(2)(B) is not self-executing.

The Whipsaw Created by the Case Law and Legislative History of Section 707(a)(2)(B). The IRS could not so easily resort to relying on legislative history or case law because of the whipsaw created by (1) case law in favor of the taxpayers and (2) congressional intent in enacting Section 707(a)(2)(B) to override this case law; however the existing regulations on disguised sale of property do not overturn the result reached in *Otey*. This further supports the conclusion that regulations under Section 707(a)(2)(B) are a precondition to its effectiveness because the statute is exceedingly broad, and even with due consideration given to legislative history and case law, the application of the statute is highly uncertain until final regulations are issued. This also undermines the influence of the legislative history and the extent, if any, that Section 707(a)(2)(B) may be self-executing in nature.

Moreover, the situation of Section 707(a)(2)(B) vis-à-vis disguised sales of partnership interests is distinct from one in which no regulations whatsoever have been issued. Even if Congress intended for Section 707(a)(2)(B) to be self-executing, it is highly questionable whether the statutory provision could retain any effectiveness with respect to disguised sales of partnership interests after the IRS tried and spectacularly failed to implement the section through regulations.

This failure, combined with a significant period of subsequent inaction by the IRS, arguably eviscerates whatever had remained, if anything, of the effectiveness of Section 707(a)(2)(B) with respect to disguised sales of partnership interests. If the administrative agency with special expertise has not yet determined a rational manner in which to implement this provision, it is highly questionable whether the IRS could still legally assert, under such provision, a disguised sale of a partnership interest claim against a taxpayer.

Conclusion. There is nothing inherently abusive about contributions to and distributions from a partnership. Actually, the intent of Subchapter K is to enable such nontaxable contributions and distributions. It is not easy to draw a distinction between such events and a disguised sale of a partnership intent. Section 707(a)(2)(B) authorizes the IRS to do so—if it can. The application of this statute to disguised sales of partnership interests is made difficult by the fact that partnerships routinely receive contributions from,

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and make distributions to, partners in the normal course of business, as the partnership's activities change and as the situation of the partnership and its partners change over time. It appears that the IRS recognizes the difficulty of providing for meaningful distinctions.

The regulations promulgated under Section 707(a)(2)(B) concerning disguised sales of property are very thorough. Many different types of potential disguised sales, and exceptions, are addressed at length. However, the IRS has not been able to come up with similar rules for all specifically reserved regulations on disguised sales of partnership interests for more than 30 years. This is because the lines are hard to draw.

The retraction of the Proposed Regulations and subsequent IRS inaction, even more so, results in the statutory provision essentially being currently unenforceable on the issue. Unless and until the IRS can figure out how to implement this provision in regulations, the IRS has a weak legal basis, if any, to claim a disguised sale of a partnership interest under Section 707(a)(2)(B). Although Section 707(a)(2)(B) was enacted to address (among other things) disguised sales of partnership interests, it is in abeyance on this particular issue. Therefore, the legal basis for the IRS to claim a disguised sale of a partnership interest is generally in a state of temporary suspension.

We welcome our readers' views, as always.

Shop Talk thanks Sam for his insightful commentary. Discussions of Section 707(a)(2)(B) have not previously focused on the doctrine of "spurned delegations," but this may be a classic situation for the application of this doctrine. Moreover, the increased focus on the need for the IRS to take regulatory steps (see *Altera*, *Mayo*, and *Home Concrete*) heightens this issue. The IRS's power to issue regulations is limited, but its power to act when it fails to issue regulations may be even more circumscribed. ●