Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part II–Property Acquisitions)

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Deborah Fields, Holly Belanger and Eric Lee, in Part II, examine the issues associated with forming a natural resources PTP, explain how the formation transaction affects the capital accounts of the unitholders and the PTP's tax shield, and address the different U.S. federal income tax consequences that can stem from the formation transaction.

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I. Introduction

This article is the second installment of a multiple-part primer regarding the unique and complex set of U.S. federal income tax issues associated with the formation and operation of a natural resources publicly traded partnership (PTP). Part I of this primer ("Part I") was published in the December issue of TAXES—The Tax Magazine. As was indicated in Part I, this primer focuses primarily on natural resources PTPs, such as exploration and production ("E&P" or "upstream"), pipeline ("midstream"), and refining or marketing ("downstream") companies. Nonetheless, many of the issues discussed in this primer are common to all PTPs (including PTPs the activities of which are financial in nature), as well as to partnerships in general.

Part I provided background information regarding natural resources PTPs, explored why PTPs may want to be classified as partnerships for U.S. federal income tax purposes and discussed the requirements that must be satisfied in order for a natural resources PTP to be classified as such. Part I also introduced several basic concepts that are critical to understanding the U.S. federal income tax issues PTPs confront (such as the typical "players" involved in a PTP structure, the types of economic rights associated with units held by the sponsor or management, and the concepts of "fungibility," "minimum cash distributions" and "tax shield"). In addition, Part I highlighted certain structural issues a sponsor may want to consider in forming a PTP—such as whether to legally organize the PTP as a limited partnership or a limited liability

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company (LLC), the potential impact of the choice of legal entity on allocations of liabilities under Code Sec. 752[1] and whether to have the PTP hold property directly or through a lower-tier entity.

This second installment of the primer delves more deeply into issues associated with forming a natural resources PTP classified as a partnership for U.S. federal income tax purposes. It begins by explaining how the formation transaction affects the capital accounts of the unitholders and the PTP's tax shield. It then addresses the different U.S. federal income tax consequences that can stem from the formation transaction, depending upon how the sponsor decides to structure the transfer of property to the PTP.[2]

II. The Role of the Capital Account–In General

A critical piece of information that is established upon the formation of a partnership is the capital account of each partner. A partner generally will have several different types of capital accounts. PTPs generally will have GAAP capital accounts for their partners. In addition, each partner will have a tax basis capital account, representing the partner's share of the partnership's basis in its assets for U.S. federal income tax purposes. Perhaps most importantly, each partner will have a capital account maintained under the rules of Code Sec. 704(b). The Code Sec. 704(b) capital account is intended to be a measure of the partner's economic entitlement under the partnership agreement.[3]

The typical PTP partnership agreement requires that the PTP establish and maintain capital accounts under the Code Sec. 704(b) rules and that the PTP liquidate in accordance with the positive capital account balances of the partners. As a result, a partner's entitlement to money in a liquidation of the partnership or in redemption of its interest is governed by such partner's Code Sec. 704(b) capital account balance. As such, the Code Sec. 704(b) capital accounts of the partners are integrally related to the economics of the PTP.

The Code Sec. 704(b) capital accounts of the PTP's initial partners are established upon the formation of the PTP. Each partner's initial capital account is credited with the amount of money and the fair market value of any property (net of any liabilities assumed by the partnership) he or she contributes to the partnership.[4] As will be discussed in a future installment of this primer, the partner's Code Sec. 704(b) capital account thereafter will be adjusted for the partner's allocable share of the partnership's items of income, gain, loss and deduction for each year. If a unitholder sells his or her units on the public market, the buyer of the units will "step into the shoes" of the Code Sec. 704(b) capital account that is attributable to the seller's units.[5]

As was explained in the first part of this primer, the fungibility of the public's units typically is of utmost importance to the sponsor of a PTP. In order for a unit to be fungible, it must not matter to a buyer on the public market from which current investor he or she is acquiring units. As a result, it is essential that each publicly traded unit have an equal entitlement to money if the PTP were to liquidate. Because the buyer of units steps into the shoes of the seller's Code Sec. 704(b) capital account, each public investor must have the same per unit capital account balance for the units to be fungible. The issues associated with maintaining fungibility as units are purchased and sold in the public marketplace will be discussed in greater detail in a subsequent installment of this primer.

III. Significance of the Formation Transaction to the Tax Shield

From an investor's perspective, the attractiveness of a unit in a particular PTP may be influenced by the PTP's tax shield.[6] Very generally, the tax shield reflects a comparison of the expected amount of annual distributions per unit and the expected share of income allocable to each unit (and subject to tax at the investor level). From the investor's perspective, it likely will be the case that the bigger the tax shield, the better; a bigger tax shield reflects a smaller ratio of taxable income to distributions. Deductions for depreciation, depletion, and amortization ("DD&A") can reduce the share of taxable income allocable to each unit. Thus as a general rule, the greater the amount of DD&A deductions allocable to a unit, the higher the tax shield.

As is explained in the discussion that follows, the sponsor's decision as to how to structure the formation of a PTP can affect the amount of DD&A deductions the PTP will be able to take and, therefore, the PTP's tax shield. In fact, because of the significance of the tax shield in the marketplace, the sponsor's structuring decisions may be influenced, in part, by their potential impact on the tax shield.

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IV. Capitalizing the PTP

Typically the sponsor of a PTP transfers property to the PTP or otherwise arranges for the PTP to acquire property, while the PTP raises capital to acquire, develop or operate the property through an initial public offering (IPO). The U.S. federal income tax issues surrounding the formation of a PTP are, in many ways, similar to the issues that have to be taken into consideration with the formation of any large partnership. However, the sponsor of a PTP may have a unique perspective on the capitalization of the partnership in several regards.

A sponsor generally transfers property to a PTP (1) by selling the property to the PTP for cash; (2) by contributing the property in exchange for interests in the PTP; or (3) by a combination of a sale and a contribution. As is explained further below, there can be, for the sponsor, different U.S. federal income tax issues associated with a sale as opposed to a contribution and the sponsor may have significant flexibility with regard to the structure. In many situations, a sale of property will trigger immediate tax to the sponsor (to the extent there is gain inherent in the property from a U.S. federal income tax perspective). On the other hand, a contribution can be structured so as to trigger no immediate tax to the sponsor. However, under the special "disguised sale" rules discussed below, a contribution can be treated as a part sale and a part contribution of the property to the PTP and, therefore, can be partially taxable and partially tax-free.

The sponsor's choice of the form of a transfer of property to the PTP may be less a choice as to *whether* to trigger the built-in gain or loss in the transferred assets and more a choice as to *when* to trigger such gain or loss—immediately upon the transfer or at a future time during the life of the partnership. Natural resources PTPs universally use the "remedial method" for accounting for the "built-in" tax gain or loss that is not triggered upon the contribution;[7] using this method results in the sponsor recognizing such built-in gain or loss over time as the property is depleted, depreciated or amortized, or upon its sale by the PTP.[8] As will be discussed in a subsequent installment of this primer, PTPs use this method in order to keep their common units fungible in the public market. Thus, while the choice of the method to account for pre-contribution built-in gain or loss can be a heavily negotiated point in the formation of other large partnerships, the need for PTP common units to be fungible in the public market essentially eliminates the sponsor's choice of methods.

The discussion below first summarizes briefly the U.S. federal income tax consequences of a sale of appreciated property by the sponsor to the partnership and explains why some sponsors structure transfers of property as sales, notwithstanding the immediate recognition of gain.[9] The discussion then addresses the U.S. federal income tax rules applicable to contributions of property by sponsors in exchange for PTP interests, including certain key exceptions to tax-free treatment. As is mentioned below, although the discussion focuses on the common situation in which the sponsor transfers property to the PTP, the concepts explained below also can be relevant to other situations such as the acquisition of property through a merger, through a contribution of property by a third party in exchange for units in a "PIPEs" transaction,[10] or through the direct purchase of the property by the PTP from a third party.

A. Transfer Structured As a Sale

As a general matter, a seller recognizes gain if it transfers appreciated property in a transaction treated as a sale for U.S. federal income tax purposes under Code Sec. 1001. In the case of such a taxable sale transaction, the buyer generally takes a basis in the property equal to its purchase price and has a new holding period in the purchased assets.[11]

In some situations, a sponsor will structure a transfer of property to a PTP as, in whole or in part, a sale for cash to monetize all or part of the value of the property. For example, as was discussed in Part I, the sponsor may want to receive some cash in order to develop property outside of the PTP, with the objective of contributing the property to the PTP in the future after its value has been enhanced, often in conjunction with a secondary public offering. Because such an approach can result in property being contributed to the PTP at a time when the property will generate significant DD&A deductions, sponsors often employ such an approach in attempting to maximize the tax shield associated with a PTP's units.

Moreover, there are some situations in which sponsors may not find recognizing gain on the transfer of property to a PTP to be exceedingly burdensome. For example, this may be the case if the amount of gain inherent in the property is relatively small (as is not uncommon in today's market environment). In addition, the sponsor's tax position (such as the availability of offsetting losses) may

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affect its willingness to recognize immediate gain, rather than deferring the gain.

The sponsor may also be able to defer the recognition of gain on a sale of the property by structuring the transaction as part of a "like-kind exchange" under Code Sec. 1031.[12] Code Sec. 1031 has several specific technical requirements that must be followed strictly, requiring diligent planning and compliance on the part of any taxpayer seeking like-kind exchange treatment.[13] For example, the ability to utilize Code Sec. 1031 depends on the ability to locate suitable replacement property within certain prescribed time constraints.

Nonetheless, sponsors who are willing to run the gauntlet of Code Sec. 1031's requirements may find structuring the transfer of property to a PTP as part of a like-kind exchange to be well worth considering. Like-kind exchanges can be a particularly attractive option for E&P PTP sponsors. As the recovery from oil and gas producing property declines over time, the depletion deductions available to the public unitholders may decline. As a result, the sponsor must look for new property to transfer to the PTP in order to maintain the tax shield. As was suggested above, to this end, the sponsor may sell property to a PTP and use the cash proceeds to acquire new, less mature, properties that the sponsor will develop and transfer to the PTP in the future. If the transfer of the "old" property and the acquisition of the "new" property can be structured as a like-kind exchange, such an approach can defer the gain on the sale of property while aiding the sponsor in renewing the tax shield of the PTP.

It is important to note that it is not necessary for the sponsor to structure the transfer of property to the PTP as a sale as a legal matter in order to monetize the property's value. As was suggested above, the sponsor instead can receive a distribution of cash from the PTP in conjunction with its contribution of property to the PTP in exchange for PTP interests. Under the disguised sale rules of Code Sec. 707(a)(2)(B), the distribution coupled with the contribution can be treated as a sale of all or part of the property for U.S. federal income tax purposes. Some sponsors affirmatively structure contributions so as to constitute disguised sales in order to monetize a portion of the contributed property. The disguised sale rules are discussed in depth below.

B. Contribution of Property to PTP

As an alternative to selling property to the PTP, the sponsor can contribute the property to the PTP in exchange for PTP interests. As is explained below, the contribution can be structured so as not to trigger any immediate recognition of gain to the sponsor or the PTP. Nonetheless, there are several exceptions to nonrecognition treatment.

1. General Rules for Tax-Free Treatment

In general, the partnership rules allow partners to enter and exit a partnership on a tax-free basis in many circumstances. For example, under Code Sec. 721(a), no gain or loss generally is recognized by a partnership or any of its partners upon the contribution of property to a partnership in exchange for an interest in the partnership. If no gain or loss is recognized on the contribution, Code Sec. 722 generally provides that the partner's basis in its partnership interest is the same as the basis of the property it contributed (*i.e.*, the partner has a "carryover basis" in its interest);[14] Code Sec. 723 generally provides that the partnership's basis in the contributed property is the same as the basis the partner had in such property prior to contribution (*i.e.*, the partnership takes the property with a carryover basis);[15] and, in the case of a contribution of a capital asset, Code Sec. 1223 generally provides that the holding periods of both the partnership interest and the partnership's property include the holding period of the contributed property.[16] Therefore, in many ways, the contribution of property by the sponsor to a PTP can be structured as essentially a continuation of the sponsor's investment in the property.

Nonetheless, to the extent a sponsor decides to contribute (rather than to sell) property to a PTP, the PTP must track any pre-contribution built-in gain or loss in the property in order to comply with the rules of Code Sec. 704(c). As will be discussed in detail in a subsequent installment of this primer, Code Sec. 704(c) requires income, gain, loss, and deduction with respect to property contributed to the partnership by a partner to be shared among the partners so as to take account of the variation between the basis of the property to the partnership and the property's fair market value at the time of contribution. Code Sec. 704(c) not only applies to allocations of gains and losses on the sale of contributed property, but also requires deductions for DD&A with respect to the property to be allocated in a manner that takes into account any difference between the tax basis of the property and its fair market value at the time of its contribution to the partnership.

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The stated purpose of the Code Sec. 704(c) rules is to prevent partners who contribute property to a partnership from shifting the tax consequences of pre-contribution gains or losses in the contributed property to other partners.[17] However, Code Sec. 704(c) can also be viewed as a mechanism for maintaining the economic deal of the partners by attempting to treat the noncontributing partners as if the sponsor had contributed property with a tax basis equal to its fair market value. It is this view that makes Code Sec. 704(c) a useful tool for sponsors of PTPs who contribute appreciated property to the PTP. Code Sec. 704(c), in effect, allows the sponsor to create tax shield for public investors from deductions for DD&A even where property contributed by the sponsor has a lower tax basis than its fair market value at the time of the contribution.

More specifically, the remedial method of Code Sec. 704(c) (which is universally employed by natural resources PTPs)[18] provides for the creation of notional items of deduction for noncontributing partners and offsetting notional items of income for the contributor of the property.[19] Therefore, through Code Sec. 704(c), a sponsor is able to give public investors the tax effect of contributed property having a tax basis equal to its fair market value at the time of the contribution, without the need to recognize all of the gain in the property up front. A subsequent installment of this primer will illustrate the mechanics of Code Sec. 704(c) and how it aids in the creation of a PTP's tax shield.

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2. Exceptions to Tax-Free Treatment– In General

As with the formation of any partnership, other rules can cause gain to be recognized on the contribution of appreciated property in exchange for a partnership interest, notwithstanding the general rule of Code Sec. 721.[20] The exception to tax-free treatment that comes into play most frequently in forming a natural resources PTP is the application of the disguised sale rules of Code Sec. 707(a)(2)(B). Because of the frequency with which the disguised sale rules arise, the discussion below addresses these rules in considerable detail.

Before turning to the disguised sale rules, however, it is worth at least mentioning some of the other rules that can cause a contribution of property to be treated as wholly or partially a taxable transaction. Although these rules may not be relevant with regard to the formation and ongoing operation of many natural resources PTPs, it is important to keep them in mind and to evaluate whether they may have any application given the facts and circumstances of a particular situation.

- **Investment Company Rules.** Code Sec. 721(b) provides that Code Sec. 721(a) "does not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (under section 351(e)) if the partnership were incorporated." A transfer of property to a corporation generally is treated as a transfer to an investment company under Reg. §1.351-1(c)(1) if both of two requirements are met: (1) the transfer results, directly or indirectly, in diversification of the transferors' interests; and (2) the transferee is a regulated investment company (RIC), a real estate investment trust (REIT), or a corporation more than 80 percent of the value of the assets of which (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities or interests in RICs or REITs (*i.e.*, the transferee is an "Investment Company"). The Taxpayer Relief Act of 1997[21] amended Code Sec. 351(e)(1) to expand the types of assets considered to determine investment company status. Although the regulation described above currently refers only to "readily marketable stocks or securities," the statutory amendment to Code Sec. 351(e) provides that all stocks and securities are included in the 80-percent test *regardless* of whether they are marketable. The amendment also provides that the following assets are treated as stocks or securities for purposes of the 80-percent test: (1) money; (2) stock and other equity interests in a corporation,[22] evidences of indebtedness, options, forward or futures contracts, notional principal contracts, or derivatives; (3) foreign currencies; (4) interests in real estate investment trusts, common trust funds, regulated investment companies or PTPs; (5) certain interests in precious metals; (6) interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of stock and securities; (7) to the extent provided in regulations, any interests in an entity not described in clause six, but only to the extent of such interest that is attributable to stock and securities; and (8) any equity interest (other than in a corporation) which pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, any asset

described in clauses 1 through 5. Because of the nature of the property typically contributed to a natural resources PTP, such a PTP usually will not constitute an investment company. As such, although the facts and circumstances of each individual situation must be considered, Code Sec. 721(b) seldom comes into play on the formation of such PTPs. However, Code Sec. 721(b) can be a significant concern to financial services PTPs, which are more likely to hold the assets listed in Code Sec. 351(e).

- **Rules Regarding "Liability Shifts" and Deemed Cash Distributions.** Code Sec. 752(b) generally treats a partner as receiving a distribution of money to the extent there is a decrease in the partner's share of liabilities in the partnership or a decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities. If the amount of such a deemed distribution of money is greater than the partner's basis in its partnership interest, the partner recognizes gain under Code Sec. 731(a). However, the Code Sec. 752 liability allocation rules are designed to minimize the risk of a Code Sec. 752(b) liability shift triggering gain on the formation of a partnership.
- **"Anti–Mixing Bowl" Rules.** Under Code Sec. 704(c)(1)(B), a partner who contributes appreciated or depreciated property to a partnership may recognize gain or loss if the partnership distributes that property, or "successor" Code Sec. 704(c) property, to another partner within seven years of the contribution.[23] Similarly, under Code Sec. 737, a partner who contributes appreciated property to a partnership may recognize gain on a subsequent distribution of other property from the partnership to the contributing partner within seven years of the contribution.[24] Because PTPs typically do not distribute property to their partners, these exceptions to nonrecognition treatment do not frequently arise in the context of the formation of a natural resources PTP.
- **Proposed Reg. §1.337(d)-3.** Regulations were proposed in 1992 relating to partnership transactions involving equity interests of partners. Under these proposed regulations, a partner may recognize gain in certain circumstances if a partnership acquires the stock of a partner or if any other transaction has the economic effect of an exchange by a partner of its interest in appreciated property for an interest in the stock of the partner owned, acquired or distributed by the partnership.[25] The regulations were proposed to be effective for any transaction that occurred after March 9, 1989, but have not been finalized. In the PTP context, it is not common for a sponsor to contribute stock of a partner to a natural resources PTP. As such, issues with regard to the potential applicability of these proposed regulations typically do not arise in forming such a PTP.

3. The Disguised Sales Rules

The disguised sale rules in Code Sec. 707(a)(2)(B) are intended to prevent a partnership from being used to defer gain on a transaction that is, in substance, a sale of property. In order to prevent taxpayers from easily circumventing the disguised sale rules, the rules are drafted broadly so as to potentially cover a wide variety of transactions.

As a general matter, under the disguised sale rules, if a contribution to a partnership and a related distribution to a partner are recast as a sale of property to the partnership, the transaction is treated as a sale for all purposes of the Code.[26] Thus, the partnership takes a purchase price basis in the property deemed purchased as well as a new holding period.[27]

The amount of the distribution that is recast as an amount realized on the sale will determine the portion of the property that will be considered to have been purchased. For example, if a partner contributes property with a fair market value of $100, and immediately receives a distribution of $50 in a transaction that is treated as a sale, only half of the property is considered to be sold to the partnership. The remaining half of the property is considered to have been contributed to the partnership under Code Sec. 721(a).[28] In the PTP context, tracking the tax consequences of this bifurcation can be burdensome when the sponsor transfers numerous properties to a partnership in a partial disguised sale transaction, such that the sponsor is considered to have sold a proportionate share (and contributed the remaining share) of each of the transferred properties.[29]

The disguised sale rules are very complex. The discussion below first summarizes the general statutory and regulatory rules for treating a contribution and a distribution as a disguised sale. Then, it addresses the exceptions to such treatment. Next, it explores the significant role liabilities can play in analyzing the potential impact of the disguised sale rules.

General Statutory and Regulatory Rules. Code Sec. 707(a)(2)(B) provides that, if there is a direct or indi-

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rect transfer of money or other property by a partner to a partnership, there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and the transfers, 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 other than in his capacity as a member of such partnership under Code Sec. 707(a) or as a transaction between two or more partners acting other than in their capacity as members of the partnership. Importantly, as is explained further below, a *deemed* distribution of cash due to the assumption of liabilities from a partner by a partnership can also give rise to a disguised sale transaction.

The regulations under Code Sec. 707(a)(2)(B) provide that the contribution of property to a partnership and a distribution of cash to the partner will be viewed as a sale only if, based on all the facts and circumstances: (1) the transfer of money or other consideration would not have been made *but for* the transfer of property; and (2) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. The regulations under Code Sec. 707(a)(2)(B) provide the following list of factors to consider in making the determination as to whether the transfers should be viewed as a sale:

- The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer.
- The transferor has a legally enforceable right to the subsequent transfer.
- The partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured.
- Any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration.
- Any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations.
- The partnership has incurred, or is obligated to incur, debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt).
- The partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets).
- Partnership distributions, allocations or control of partnership operations are designed to effect an exchange of the burdens and benefits of ownership of property.
- The transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits.
- The partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation, but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.[30]

In addition to the factors above, the regulations include two important "presumptions" affecting when a transaction may be recast as a disguised sale under Code Sec. 707(a)(2)(B). First, the regulations provide that, if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.[31] Conversely, the regulations provide that transfers that occur more than two years apart are presumed not to constitute a sale, unless the facts and circumstances clearly establish that the transfers constitute a sale.[32]

Because of the two-year presumptions, a sponsor can face an uphill battle in establishing that a distribution of cash received within two years of the contribution of property to the PTP is not part of a sale of the property to the PTP. Moreover, even in situations where the facts and circumstances clearly establish that such a distribution and contribution should not be viewed as a sale, the regulations require the disclosure of transfers that occur within two years of each other that are not treated as part of a sale,

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unless certain exceptions described below apply to the transfers.[33] Conversely, the presumptions provide the sponsor with the benefit of the doubt on transfers outside of the two-year period.

Exceptions to Disguised Sale Treatment. The regulations under Code Sec. 707(a)(2)(B) also contain several exceptions to disguised sale treatment. As is explained below, two of these exceptions often prove relevant in the PTP context. These relate to certain reimbursements of preformation expenditures and distributions of cash from operations.

Reimbursement for Preformation Expenditures. The regulations provide, in relevant part, that a transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that (1) are incurred during the two-year period preceding the transfer by the partner to the partnership, and (2) are incurred by the partner with respect to property contributed to the partnership by the partner.[34] This exception allows a partner to acquire or improve a property on behalf of a partnership and to be repaid for the costs that the partnership could have incurred itself. Importantly, the exception does not appear to be limited to situations in which the expenditures were made by the partner in anticipation of the formation of the partnership. Instead, it appears that any contributed property that was acquired or improved within the two years prior to the contribution may be eligible for reimbursement.[35]

The regulations, however, limit the availability of this exception in cases where the contributed property has a fair market value that exceeds 120 percent of its tax basis at the time of the contribution.[36] In such cases, the contributing partner is limited to a reimbursement of 20 percent of the fair market value of the property.[37] As a result, if a property has appreciated by 19 percent over its tax basis, the exception allows reimbursement of 100 percent of the capital expenditures with respect to the property within the prior two years. By contrast, if the same property has appreciated by 21 percent over its tax basis, the reimbursement would be limited to 20 percent of the fair market value of the property. Therefore, particular attention must be paid to whether and how this exception applies to a specific contributed property.[38]

Exception for Certain Distributions of Cash from Operations. The regulations recognize that the disguised sale rules should not prevent partners from being able to share in distributions of the economic returns of the partnership's business. As such, the regulations contain exceptions from disguised sale treatment with respect to three common ways in which a partner receives a share of the cash generated by the partnership's operations.[39]

The most obvious in terms of concept, and least obvious in terms of mechanics, is the exception for a partner's share of the operating cash flow of the partnership.[40] Under this exception, a distribution will not be treated as part of a sale to the extent it does not exceed the product of (1) the net cash flow of the partnership from operations for the year multiplied by (2) the lesser of (a) the partner's percentage interest in overall partnership profits for that year or (b) the partner's percentage interest in overall partnership profits for the life of the partnership.[41] The regulations provide the following formula for determining the partnership's net cash flow for the year:

- *Start*—Taxable income or loss of the partnership arising in the ordinary course of the partnership's business and investment activities
- *Plus*—Tax-exempt interest
- *Plus*—Depreciation, amortization, cost recovery allowances
- *Plus*—Noncash charges deducted in determining taxable income
- *Minus*—Principal payments made on any partnership indebtedness
- *Minus*—Property replacement or contingency reserves actually established by the partnership
- *Minus*—Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow
- *Minus*—Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss
- *Equals*—Net Cash Flow[42]

By adding back into taxable income any cost recovery deductions and taking into account items such as tax-exempt income and nondeductible expenses, the formula focuses on the actual cash returns of the partnership. However, because the formula is mechanical, it can produce some unexpected results. Therefore, close attention should be paid to the application of the formula to the particular facts.[43]

In addition to the two exceptions discussed above, the regulations allow a partner to receive a reason-

able guaranteed payment or reasonable preferred return without running afoul of the disguised sale rules.[44] Guaranteed payments and preferred returns are two ways in which partners can take priority shares of the economic returns of the partnership.[45] The payment of a guaranteed payment for the use of a partner's capital, or the distribution of money attributable to a preferred return, is not considered to be part of a sale as long as the sum of the payments is reasonable in amount.[46] "Reasonable" is defined in the regulations as not being in excess of the partner's unreturned capital,[47] multiplied by an interest rate equal to 150 percent of the highest applicable federal rate, at the appropriate compounding period or periods, in effect at any time between when the payment is added to the agreement and the end of the tax year.[48] While this exception is very useful for many partnerships, PTP partnership agreements historically have not often provided for guaranteed payments and preferred returns payable within two years of the formation of the PTP. The type of additional economic return from a partnership that typically are satisfied by a reasonable preferred return or guaranteed payment are, in the PTP context, more commonly factored into the return on any incentive distribution rights (IDRs), management incentive units (MIUs) or other incentive interests.[49] Thus, these exceptions have been used less frequently by sponsors of PTPs than the exception for reimbursement of preformation expenditures and operating cash flow distributions.

Role of Liabilities in Disguised Sales. An often overlooked component of the disguised sale analysis is the impact liabilities have on the amount of gain potentially recognized. It should come as no surprise that liabilities would come into play in a disguised sale scenario, given that the general rules of the Code include liabilities in the amount realized upon the a sale of encumbered property.[50] As such, the Treasury and the IRS could have written rules that would treat the assumption of any liability in connection with the contribution of encumbered property as proceeds from a sale of the property. However, the disguised sale regulations instead generally attempt to treat liability assumptions within the normal functioning of a partnership as not giving rise to a sale in those situations in which a sale otherwise would not have existed. To achieve this, the Code Sec. 707(a)(2)(B) liability rules generally look to the extent to which a contributing partner has used a liability to "cash out" of the property.

The disguised sale regulations divide the universe of liabilities into two categories—liabilities that are "qualified" and those that are not. If a liability is qualified, its assumption by the partnership generally will only be treated as the proceeds of a sale to the extent that the transaction already is treated as a sale under Code Sec. 707(a)(2)(B).[51] Thus, the partnership's assumption of this special category of liabilities cannot, on its own, create a sale transaction. The regulations provide four categories of qualified liabilities:

- A liability (1) that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership, and (2) that has encumbered the transferred property throughout that two-year period.[52] This category encompasses "old and cold" liabilities that are unlikely to have been incurred in anticipation of the formation of the partnership. It does not matter what the proceeds of the borrowing were used for in order for this type of liability to be considered qualified. However, special attention should be paid to make sure that the liability has encumbered the contributed property for the last two years.
- A liability that is allocable under the interest tracing rules[53] to capital expenditures with respect to the property.[54] The logic behind making this kind of liability "qualified" appears to be that, where the proceeds of the borrowing are put into the property through the acquisition or capital expenditures, it cannot generally be said that the partner has used the liability to "cash out" of the property. Moreover, the partnership itself could have borrowed the funds and acquired the property.
- A liability that was incurred in the ordinary course of the trade or business in which the property transferred to the partnership was used or held, but only if all the assets related to that trade or business are transferred (other than assets that are not material to a continuation of the trade or business).[55] This category takes into account the types of trade or business liabilities that would be expected to be part of the contribution of a trade or business to a partnership.
- A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that (1) was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the

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property to the partnership; and (2) has encumbered the transferred property since incurred.[56] This category appears to be intended to include liabilities that do not meet the other three categories of qualified liabilities (for example, newer debts where the proceeds were used for purposes unrelated to the partnership), but that nonetheless do not evidence an attempt by the contributing partner to cash out of the contributed property. Importantly, however, a liability incurred within two years of the contribution that is not in the second or third categories described above is presumed to have been incurred in anticipation of the transfer unless the facts and circumstances clearly establish otherwise.[57] Further, the contributing partner is required to disclose on its return that it is treating a liability as a qualified liability under this category.[58]

As mentioned above, the ability to exclude qualified liabilities from potential proceeds realized in a disguised sale is limited to those situations in which the contributing partner has not received any other consideration that is treated as part of a disguised sale. Where the contribution is otherwise treated as a disguised sale, the regulations provide that a portion of any qualified liability also will be considered amount realized on the sale.[59] This portion is the lesser of (1) the amount that would be considered proceeds if the liability were not a qualified liability; and (2) the amount obtained under a formula provided in the regulations.[60] This formula incorporates a proportionate share of the qualified liability to consider as an additional amount realized on the sale. Specifically, the formula is shown in Chart 1.

Chart 1.

$$\text{Amount of qualified liability} \times \frac{\text{Other disguised sale proceeds (incl. nonqualified liabilities)}}{\text{FMV of the property } \textit{minus} \text{ the qualified liability}^{1}}$$

1 Reg. §1.707-5(a)(5).

Unlike a qualified liability, a partnership's assumption from a partner of a liability that is not a qualified liability can, on its own, create a disguised sale under Code Sec. 707(a)(2)(B). The disguised sale rules relating to nonqualified liabilities generally are based on how liabilities are allocated for purposes of determining their impact on a partner's basis under Code Sec. 752. Code Sec. 752 allocates liabilities among the partners with the view that the partners remain economically "on the hook" in some way for the payment of the liabilities. The disguised sale rules borrow from that view to determine the extent to which the burden for the payment of a liability assumed by the partnership has shifted to the other partners. For recourse liabilities (*i.e.*, liabilities for which a partner or person related to a partner bears the economic risk of loss), the regulations measure the shift in the burden by comparing the amount of the liability with the contributing partner's Code Sec. 752 share after the contribution.[61] The contributing partner is generally considered to have received proceeds on a disguised sale to the extent that the amount of the recourse liability assumed from the contributing partner by the partnership exceeds such partner's share of the liability under Code Sec. 752.

The rule for nonrecourse liabilities (*i.e.,* liabilities for which only the creditor bears the economic risk of loss) is less obvious. Rather than following the way in which the liabilities are allocated under the Code Sec. 752 nonrecourse liability rules, the disguised sale rules apply a modified version of the Code Sec. 752 rules. For nonrecourse liabilities, Code Sec. 752 employs a three-tier allocation scheme.[62] For purposes of the disguised sale rules, however, the amount a nonrecourse liability shifts away from the contributing partner is determined as if the entire liability were allocated under the third tier.[63] The allocation under the third tier can vary by partnership, but the default is for the allocation to be based on the partners' sharing of profits.[64] By using only this tier, the disguised sale rules look to how the partner's share of partnership profits will be burdened by the payment of the liability by the partnership. In situations in which a partner will be contributing nonqualified liabilities that may give rise to proceeds on a disguised sale, the partner may consider whether he or she would be willing to guarantee the liability to prevent the liability from shifting to other partners.

In a situation in which a sponsor wishes to monetize a portion of the value of property it contributes to the PTP, the sponsor may want to consider using the rules regarding nonqualified liabilities, as opposed to having the PTP distribute a portion of the money received from the public in the IPO. Because only the portion of a nonqualified liability that shifts to the public unitholders is treated as giving rise to amount realized on a sale, the sponsor may be able to borrow against the value of the contributed property, retain the proceeds of the borrowing and be treated as having a smaller amount realized

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Chart 2.

The partner's share of the liability determined under the non-qualified liability rules	x	The amount of the proceeds of the borrowing distributed to the partner / The total amount of the liability[1]

[1] Reg. §1.707-5(b)(2)(i).

than if public money had been distributed to the partner. For example, assume that a sponsor is forming a PTP in which the sponsor will have a 55-percent profit share and the sponsor wishes to receive $100 on formation. If $100 in cash is distributed to the sponsor out of the public's money, the full $100 will be presumed to be proceeds in a disguised sale unless one of the exceptions discussed above applies. In contrast, if the sponsor were to borrow $100 on a nonrecourse basis against the value of the contributed property and retain the $100, only $45 (*i.e.,* the amount of the liability that would be considered to have shifted under the nonqualified liability rules) would be treated as amount realized on a disguised sale. While the drawback is that the PTP would have $100 of additional liabilities on its books at formation, the sponsor may want to consider whether this is an attractive alternative.

Rather than having the partnership assume liabilities from the sponsor in connection with the contribution of property, it is also possible that the PTP may encumber the contributed property after the contribution and distribute the proceeds of the borrowing to the sponsor. To the extent the distribution is made within two years of the contribution, the transfers would generally be within the two-year presumption for disguised sales described above. However, the disguised sale liability rules also include an alternative, pursuant to which a partner is allowed to borrow money through the partnership and receive a distribution of money that will, at least in part, be respected as a partnership distribution rather than as proceeds from a disguised sale. The regulations provide that, if a partner transfers property to a partnership, the partnership incurs a liability, and all or a portion of the proceeds of that liability are allocable under the interest tracing rules[65] to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.[66] For purposes of this "debt-financed distribution rule," a partner's share of the liability is determined as shown in Chart 2.

The formula itself highlights an important issue to note when considering a debt-financed distribution: The rule generally does not allow a partner to withdraw a dollar-for-dollar share of the proceeds of the borrowing. For example, the fact that a partner would have a $50 share of a $100 liability under the nonqualified liability rules does not translate into the partner being able to receive a distribution of $50 as a tax-free debt-financed distribution. Based on the formula in the regulations, under these simple facts every dollar distributed to the partner includes $0.50 taken from the other partners' share of the debt proceeds.[67] Therefore, while a debt-financed distribution can be a useful alternative to receiving a distribution of the public's contributed money where a sponsor wishes to monetize a portion of the value of contributed property, consideration should be given to the impact of the formula on the distribution.

C. Acquisition of Property by the PTP Through a Merger

As an alternative to the sponsor contributing property to the PTP, the sponsor may consider merging an existing entity that currently holds property into the PTP. The U.S. federal income tax consequences of such a merger will largely depend on whether the entity that is merging into the PTP is regarded for U.S. federal income tax consequences.[68] For example, if the sponsor merges a wholly owned limited liability company that is classified as a disregarded entity[69] into the PTP, the U.S. federal income tax consequences will generally be the same as a direct contribution of the property by the sponsor as discussed above.

If the entity that is merged into the PTP is classified as a partnership for U.S. federal income tax purposes, however, additional complexities may be raised. The partnership merger regulations generally provide that the merged entity is considered a continuation of the partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership.[70] In situations where the sponsor

intends to hold more than 50 percent of the PTP after the merger, this could mean that either the PTP or the merging entity could be viewed as the continuing partnership. To break such a "tie," the regulations provide that, if the merged partnership could be viewed as the continuation of more than one of the merging partnerships, it will be considered to be a continuation of the partnership that is credited with the contribution of the assets with the greatest fair market value.[71] The other partnerships involved in the merger transaction will be considered to have terminated for U.S. federal income tax purposes, even in situations where the merged entity continues to exist for state law purposes.[72]

The determination of which partnership is considered to be the continuing partnership for U.S. federal income tax purposes can produce some unexpected results in connection with the formation of a PTP. Specifically, where the existing entity holds all of the property that will be held by the PTP, it is possible that the PTP will be considered a continuation of the existing entity for U.S. federal income tax purposes. This may be the opposite of the state law outcome of the transaction and can catch sponsors off-guard with regard to the proper employer identification number (EIN) to be used by the PTP. The regulations provide that the merged entity must continue to use the EIN of the partnership deemed to be the continuing partnership for U.S. federal income tax purposes.[73] However, it is common for the sponsor to apply for a new EIN for the newly formed PTP state law partnership and to use this EIN on all public filings. This often is done before the sponsor has determined how the PTP will be capitalized. In such a situation, applying the rule in the merger regulations may be inconsistent with the PTP's public filings.[74]

A merger of an existing entity into the PTP also can create additional complexity in tracking the built-in gain or loss in the property acquired in the merger. The partnership merger regulations provide a "default form" for the accomplishment of a partnership merger. The regulations generally provide that the merged or consolidated partnership that is considered terminated is deemed to contribute all of its assets and liabilities to the continuing partnership in exchange for an interest in the continuing partnership, and immediately thereafter, the terminated partnership is deemed to distribute interests in the resulting partnership to its partners in liquidation of the terminated partnership.[75] Additional complexity may result with regard to the application of Code Sec. 704(c) to the extent the terminating partnership was required to track built-in gain or loss in its property prior to the merger. How this pre-merger built-in gain or loss is to be taken into account by the partnership is not entirely clear. Although the IRS and the Treasury have issued proposed regulations that are intended to address some of the uncertainty,[76] the proposed regulations raised some additional questions about the proper application of the Code Sec. 704(c) rules in the context of a merger, with respect to which the IRS and the Treasury have invited public input.[77]

D. Purchase of Property by the PTP from a Third Party

Where the sponsor does not currently hold the property that will make up the operating assets of the PTP, it may be desirable for the PTP to purchase the assets directly from a third party. This often involves the sponsor first negotiating for the acquisition of the property, and then assigning the purchase agreement to the newly formed PTP.

If the decision is made that the PTP will acquire its operating assets directly from a third party, the sponsor must determine how the purchase will be funded. As with the decision making process above regarding whether to contribute or sell the property to the partnership, the decision with regard to funding the PTP's acquisition may be determined based on the cash needs of the sponsor. A sponsor with cash on hand to contribute to the PTP's business may fund all or a part of the purchase price of the assets. A sponsor without the luxury of cash to invest in the venture may be forced to look to the public's investment or a loan to fund the acquisition. In making this decision, the sponsor must weigh the PTP's need for operating capital with the possible negative rating agency impact of leveraging the PTP at the time of its formation.

V. Conclusion

The above discussion highlights some of the partnership tax issues that the sponsor will face in deciding how the sponsor may acquire its units and the PTP may acquire its property. The next installment of this primer will pick up with the U.S. federal income tax issues surrounding the admission of the public and management to the PTP. It also will focus on some of the unique U.S. federal income tax issues arising from the operation of a natural resources PTP (including the difficulties that a natural resources PTP will face in applying the allocation provisions in its partnership agreement).

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Endnotes

* The authors wish to express appreciation to Carol Kulish Harvey, also with the WNT Passthroughs Group, for her substantial contribution to this article. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax advisor. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

[1] Except to the extent provided otherwise, all Code Sec. references are to the Internal Revenue Code of 1986, as amended ("the Code"), or to the Treasury regulations promulgated thereunder.

[2] As was indicated in Part I, this primer is limited in scope to a discussion of certain tax issues. It does not address other issues, such as legal, regulatory or accounting issues.

[3] The regulations under Code Sec. 704(b) provide rules regarding when a partnership's allocations of tax items are to be respected for U.S. federal income tax purposes. Very generally, allocations of partnership items under a partnership agreement must have substantial economic effect (within the meaning of Code Sec. 704(b)) or be in accordance with the partners' interests in the partnership. In order for an allocation to have "substantial economic effect" under the Code Sec. 704(b) regulations, among other requirements, the partnership agreement must provide for the determination and maintenance of the partners' capital accounts in accordance with certain specific rules set forth in Reg. §1.704-1(b)(2)(iv).

[4] Reg. §1.704-1(b)(2)(iv)(b).

[5] Reg. §1.704-1(b)(2)(iv)(l).

[6] This primer is not intended to provide advice to investors as to the tax consequences of investing in a PTP. The tax consequences to each investor may vary depending upon such investor's particular facts and circumstances. A potential investor should seek advice from his or her own tax counsel regarding the tax consequences of investing in a particular PTP.

[7] There are some financial services PTPs that do not utilize the remedial method (and that do not have a Code Sec. 754 election in effect). This often is the case with partnerships employing mark-to-market accounting, which minimizes the need for the use of such approach.

[8] The remedial method is described in regulations issued under Code Sec. 704(c). *See* Reg. §1.704-3(d). A subsequent issue of this primer will examine the remedial method in more detail.

[9] The discussion below generally assumes that there is gain inherent in the property from a U.S. federal income tax perspective (*i.e.*, the fair market value of the property exceeds the tax basis of the property). If instead there is a loss inherent in the property (*i.e.*, the property's tax basis exceeds its fair market value), consideration should be given to the potential application of special rules applicable to losses, such as rules that can preclude loss recognition (*e.g.*, Code Secs. 267 and 707(b)(1)) and rules regarding the allocation of a "built-in loss" by a partnership (*e.g.*, Code Sec. 704(c)(1)(C)).

[10] As was explained in Part I, PTPs have been raising an increasing amount of capital through private placement transactions known as PIPEs—*i.e.*, Private Investment in Public Entities. In a PIPEs transaction, large investors, such as institutional investors and investment funds, typically negotiate directly with the PTP to purchase a large volume of the same common units that are issued to public investors, but at a discounted rate. The units issued in the PIPEs transaction often cannot be registered for sale on the public market for a certain period of time.

[11] *See generally* Code Secs. 1012 and 1223.

[12] Code Sec. 1031 generally allows a taxpayer to defer the recognition of gain where property held for productive use in a trade or business or for investment is exchanged for property of like-kind that will also be held for productive use in a trade or business or for investment.

[13] A complete discussion of the like-kind exchange rules is beyond the scope of this article. However, structuring the sale of property to a partnership as part of a like-kind exchange under Code Sec. 1031 will generally require the assistance of an unrelated third party (*e.g.*, a qualified intermediary within the meaning of Reg. §1.1031(k)-1(g)) to facilitate the exchange transaction. After the sponsor sells its property to the partnership, the qualified intermediary generally receives the consideration for such property directly from the partnership. The sponsor will have 45 days from the date of the transfer to the partnership to identify the potential replacement properties that may be acquired in the exchange and 180 days from the date of the transfer to the partnership to acquire some or all of the identified properties. *See* Code Sec. 1031(a)(3); Reg. §1.1031(k)-1.

[14] Code Sec. 722 provides that the basis of a partnership interest acquired by a contribution of property, including money, to the partnership is the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution, increased by any gain recognized under Code Sec. 721(b) (discussed in text *infra*) to the contributing partner at such time.

[15] Code Sec. 723 generally provides that the basis of property contributed to a partnership by a partner is the adjusted basis of such property at the time of the contribution increased by any gain recognized under Code Sec. 721(b) to the contributing partner at such time.

[16] Code Sec. 1223 generally provides that, in determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and the property exchanged at the time of such exchange was a capital asset as defined in Code Sec. 1221 or property described in Code Sec. 1231. A partner can have a "divided" holding period in a partnership interest if the partner either (1) acquired portions of the interest at different times or (2) acquired portions of the interest in exchange for property transferred at the same time but with different holding periods. The portion of the interest to which a holding period relates generally is determined by reference to the ratio of the fair market value of the interest received in the transaction to which the holding period relates to the fair market value of the entire interest (immediately after the transaction). *See generally* Reg. §1.1223-3(a) and (b).

[17] *See, e.g.*, Reg. §1.704-3(a)(1).

[18] As indicated in note 7, *supra*, some financial services PTPs do not use the remedial method.

[19] As will be explained further in a subsequent installment of this article, the remedial method of Code Sec. 704(c) is also key in maintaining the fungibility of the public investors' units.

[20] As indicated in note 9, *supra*, this discussion generally assumes that there is a tax gain (rather than a loss) inherent in the contributed property.

[21] Act Sec. 1002(a) of P.L. 105-34.

[22] For this purpose, stock and securities in a "subsidiary" corporation are disregarded and the parent corporation is deemed to own its ratable share of the subsidiary's assets. A corporation is generally considered a subsidiary if the parent owns at least 50 percent of the combined voting power or the total value of shares of all classes of stock outstanding. Reg. §1.351-1(c)(4).

[23] Code Sec. 704(c)(1)(B) provides that, if property is contributed to a partnership

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and, within seven years of contribution, such property is distributed to another partner, the contributing partner is treated as recognizing gain or loss from the sale or exchange of such property (*i.e.*, on the distribution) in an amount equal to the amount of gain or loss that would have been allocated to such partner under Code Sec. 704(c)(1)(A) had the property been sold by the partnership for its fair market value at the time of the distribution. If Code Sec. 704(c) property is subsequently contributed to a lower-tier partnership, the interest in the lower-tier partnership received in exchange for the Code Sec. 704(c) property is treated as successor Code Sec. 704(c) property. Reg. §1.704-3(a)(8).

[24] Code Sec. 737 generally provides that, in the case of a distribution by a partnership to a partner, such partner shall be treated as recognizing gain in an amount equal to the lesser of (1) any excess of the value of the property (other than money) received in the distribution over the partner's basis in its partnership interest reduced (but not below zero) by the amount of money distributed, or (2) the "net precontribution gain" of the partner. Net precontribution gain generally is the net gain that would be recognized by the distributee partner under Code Sec. 704(c)(1)(B) if all the property the partner had contributed to the partnership within the previous seven years that is still held by the partnership were distributed by the partnership to another partner.

[25] *See* Proposed Reg. §1.337(d)-3(d) and (h), Example 3, 57 FR 59324 (Dec. 15, 1992).

[26] Reg. §1.707-3(a)(2).

[27] The partnership, having newly purchased the property, will have a new placed-in-service date for depreciation or amortization purposes as well.

[28] *See, e.g.*, Reg. §1.707-3(f), Example 1.

[29] The IRS included an explicit rule against the "cherry-picking" of high basis properties in the proposed disguised sale regulations. Prop. Reg. §1.707-3(e), 56 FR 19055 (Apr. 25, 1991). In response to criticism that this was inconsistent with some existing case law, under which specific identification of property may be appropriate where a business purpose exists, this rule was removed from the final regulations. T.D. 8439, 57 FR 44974 (Sept. 30, 1992). However, this appears to be an area for caution.

[30] Reg. §1.707-3(b)(2).

[31] Reg. §1.707-3(c)(1).

[32] Reg. §1.707-3(d).

[33] Reg. §1.707-3(c)(2). Under the regulations, disclosure is made on a completed Form 8275 or on a statement attached to the return of the transferor of the property for the taxable year of the transfer. Reg. §1.707-8(b).

[34] Reg. §1.707-4(d). A partner may also be reimbursed for partnership organization and syndication costs under Code Sec. 709. *Id.* The impact of the organization and syndication costs associated with a PTP will be discussed in a subsequent installment of this primer.

[35] It should be noted that, while the reimbursement for preformation expenditures is an exception to disguised sale treatment, it does not eliminate the requirement of disclosure for transfers within two years of each other that are not treated as part of a sale. *See, e.g.*, Reg. §1.707-3(c)(2)(iii).

[36] *Id.*

[37] *Id.*

[38] To the extent the sponsor contributes multiple properties to the PTP, consideration should also be given to whether the fair market value limitation applies to the contribution as a whole (taking into account the net appreciation in all of the assets contributed by the sponsor) or whether the limitation is more properly applied to each contributed property on a property-by-property basis. For a more detailed discussion of this issue, *see* Gregory J. Marich and Barksdale Hortenstine, *A Comprehensive Guide to Interpreting and Living with the Rules Governing Disguised Sales of Property*, 2006 TNT 59-35 (2006).

[39] It should be noted that, unlike in the case of the exception for reimbursement of preformation expenditures, the use of these exceptions does not require disclosure for transfers within two years that are not treated as part of a sale. Reg. §1.707-3(c)(2).

[40] Reg. §1.707-4(b).

[41] Reg. §1.707-4(b)(2)(i).

[42] Reg. §1.707-4(b)(2)(i). Note that the regulation does not define "reserves" or "contingency reserves" for purposes of this formula.

[43] For example, the disconnect between the net cash flow definition and the Code Sec. 704(b) rules is discussed in Gregory J. Marich and Barksdale Hortenstine, *A Comprehensive Guide to Interpreting and Living with the Rules Governing Disguised Sales of Property*, 2006 TNT 59-35 (2006).

[44] Reg. §1.707-4(a).

[45] Generally, the difference between a guaranteed payment and a preferred return is the capacity in which the partner receives payment. Under Code Sec. 707(c), a guaranteed payment is, for some purposes, treated as made to one not acting in their capacity as a partner, and is similar to an interest charge for the use of the partner's capital or compensation for services performed by the partner. A preferred return, in contrast, generally is a priority allocation of partnership profits to a partner, which may be matched with an immediate distribution of money.

[46] Reg. §1.707-4(a)(3)(i). In addition, the payments must have been provided for in the partnership agreement.

[47] Unreturned capital generally is determined at the beginning of the tax year. However, the partner has the option of looking to the weighted average capital balance for the year. Reg. §1.707-4(a)(3)(ii). This allows the partner to take into account capital contributions made during the year.

[48] Reg. §1.707-4(a)(3)(ii).

[49] *See* Part I for a discussion of IDRs, MIUs and other incentive interests.

[50] Reg. §1.1001-2(a)(1).

[51] Reg. §1.707-5(a)(5)(i).

[52] Reg. §1.707-5(a)(6)(i)(A).

[53] Reg. §1.163-8T.

[54] Reg. §1.707-5(a)(6)(i)(C).

[55] Reg. §1.707-5(a)(6)(i)(D).

[56] Reg. §1.707-5(a)(6)(i)(B).

[57] Reg. §1.707-5(a)(7)(i).

[58] Reg. §1.707-5(a)(7)(ii).

[59] Reg. §1.707-5(a)(5)(i).

[60] *Id.*

[61] Reg. §1.707-5(a)(2)(i).

[62] Reg. §1.752-3(a).

[63] Reg. §1.707-5(a)(2)(ii).

[64] Reg. §1.752-3(a)(3). It should be noted, however, that the Code Sec. 752 regulations allow a partnership the option of first allocating the third tier based on any remaining built-in gain in the partnership's assets after the application of the second tier. *Id.*

[65] Reg. §1.163-8T. One complication in taking advantage of the debt-financed distribution exception is that, because the regulations refer to the interest tracing rules, tracing the proceeds of the borrowing to the distribution made to a partner may create an additional burden in determining the deductibility of interest. However, this is less of a concern in the case of the formation of a PTP, where the sponsor likely would employ the distributed proceeds from the borrowing in its trade or business.

[66] Reg. §1.707-5(b)(1).

[67] It should be noted that the regulations contain a variation on the rule for situations in which the partnership makes debt-financed distributions to multiple partners pursuant to a plan, in which the formula looks to the total percentage of the proceeds distributed pursuant to the plan. Reg. §1.707-5(b)(2)(ii).

[68] Under Reg. §1.7701-3(b)(1), unless a business entity is a *per se* corporation or elects to be classified as a corporation, a domestic entity with a single owner is disregarded as an entity separate from its owner for U.S. federal income tax purposes.

[69] As indicated in note 69, *supra*, the wholly owned limited liability company cannot be classified as a disregarded entity if it has

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elected to be classified as a corporation for U.S. federal income tax purposes.

[70] Reg. §1.708-1(c)(1).

[71] *Id.*

[72] *Id.* This is in contrast to situations in which the sponsor contributes to the PTP a portion of the interests in an existing partnership, while retaining the remainder of the partnership interests, such that the existing partnership will continue to be regarded for U.S. federal income tax purposes. However, the sponsor must be wary of whether the contribution would cause the existing partnership to technically terminate under Code Sec. 708(b)(1)(B). Because a technical termination will cause depreciation to re-start on any depreciable property held by the partnership, this can be a harsh result. *See* Code Sec. 168(i)(7).

[73] Reg. §1.708-1(c)(2).

[74] Moreover, the EIN guidance relating to employment taxes contradicts the merger rules. *See, e.g.,* Reg. §1.6109-1(h). For an in-depth discussion of the difficult interaction between the partnership merger rules and the rules relating to EINs *see* the letter from KPMG, LLP (KPMG) to Commissioner Shulman of the IRS, dated May 19, 2009, 2009 TNT 105-15 (June 4, 2009).

[75] Reg. §1.708-1(c)(3)(i).

[76] FR 46932 (Aug. 22, 2007).

[77] Notice 2009-70, IRB 2009-34, 255 (Aug. 24, 2009).

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