



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Transactions Between Partner and Partnership

This Field Service Advice responds to your memorandum dated March 4, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

R	=
S	=
t	=
<u>u</u>	=
<u>v</u>	=
<u>w</u>	= \$

ISSUES:

1. Whether a payment by the limited liability company to a partner is treated as a sale or exchange under section 707.
2. Whether the anti-abuse regulations promulgated under section 701 apply to the transaction.

CONCLUSION:

1. The payment by the limited liability company to the partner is treated as a sale or exchange under section 707, allowing the limited liability company a cost basis in the assets considered purchased.
2. The anti-abuse regulations promulgated under section 701 do not apply to the transaction.

FACTS:

R, a not-for-profit corporation, owns and operates a hospital and clinic. R planned to expand and remodel its existing facilities and construct new facilities. The cost of such expansion, remodeling, and construction was estimated to be \$w over t years. In order to carry out the expansion, remodeling and construction, R and S, a corporation, agreed to form a limited liability company, which would be taxed as a partnership, wherein R would contribute certain of its assets in exchange for a u percent interest and S would contribute cash in exchange for a v percent interest. Subsequent to the contributions to capital, to adjust the capital accounts so that R would own a u percent interest and S would own a v percent interest, the limited liability company made an adjusting payment to R. The limited liability company filed a Form 8594, Asset Acquisition Statement Under Section 1060, reporting the amount of the payment to R as a disguised sale under section 707 and claimed a cost basis in the assets to the extent of the payment.

LAW AND ANALYSIS

In general, no gain or loss is recognized upon the contribution of property to a partnership in exchange for a partnership interest. I.R.C. § 721(a). Accordingly, under the general rule, R and S do not recognize gain upon the contribution of assets and cash to the limited liability company in exchange for an interest in the limited liability company.

In general, the partnership's basis in property contributed to the partnership by a partner is the adjusted basis of the property to the contributing partner at the time

of the contribution. I.R.C. § 723. Accordingly, under the general rule, the limited liability company's basis in the assets contributed by R is R's adjusted basis in the assets prior to contribution.

Transaction Between a Partner and the Partnership

If a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, the transaction is considered as occurring between the partnership and one who is not a partner. I.R.C. § 707(a)(1). Such transactions include the sale of property by the partner to the partnership. Treas. Reg. § 1.707-1(a). If a partner transfers property to a partnership, there is a related direct or indirect allocation and distribution to such partner, and the transfer and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such distribution shall be treated as occurring between the partnership and one who is not a partner. I.R.C. § 707(a)(2)(A); Treas. Reg. § 1.707-3(a)(1).

A transfer of property by a partner to a partnership and a transfer of money by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership if, based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of property and, in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership operations. Treas. Reg. § 1.707-3(b)(1). The weight to be given each of the facts and circumstances will depend on the particular case. Treas. Reg. § 1.707-3(b)(2). The following facts and circumstances may tend to prove the existence of a sale:

- that the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;
- that the transferor has a legally enforceable right to the subsequent transfer;
- that 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 secure;
- that 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;

- that 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;
- that 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;
- that 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;
- that partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;
- that 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; and
- that 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.

Treas. Reg. § 1.707-3(b)(2)(i) through (x). If within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner, 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. Treas. Reg. § 1.707-3(c)(1).

R transferred the assets to the limited liability company and there was a subsequent distribution of cash to R. Because the transaction occurred within a two-year period, the transfer is presumed to be a sale of the property to the partnership. No facts were presented which would clearly establish that the transfer did *not* constitute a sale. Accordingly, R is considered to have sold a portion of the contributed assets to the limited liability company in exchange for cash. R must realize gain to the extent the amount realized exceeds the adjusted

tax basis. Treas. Reg. § 1.707-3(f) Ex. 1. (To the extent permitted by section 501(a), the gain is exempt from taxation. I.R.C. § 501(a), (c)(3).) The limited liability company has a cost basis in the assets which are treated as having been purchased from R pursuant to section 707(a)(a). I.R.C. § 1012; Treas. Reg. § 1.707-3(a)(2).

Anti-abuse Regulations

The partnership provisions of subchapter K are intended to permit taxpayers to conduct joint business activities through a flexible economic arrangement without incurring any entity-level tax. Treas. Reg. § 1.701-2(a). To come within the intent of subchapter K

- the partnership must be bona fide and each partnership transaction or series of related transactions must be entered into for a substantial business purpose;
- the form of each partnership transaction must be respected under substance over form principles;
- in general, the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income.

Treas. Reg. § 1.701-2(a)(1) through (3). If a partnership is formed or availed of in connection with a transaction, a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Treas. Reg. § 1.701-2(b). Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. Treas. Reg. § 1.701-2(c). The factors which are considered include the following:

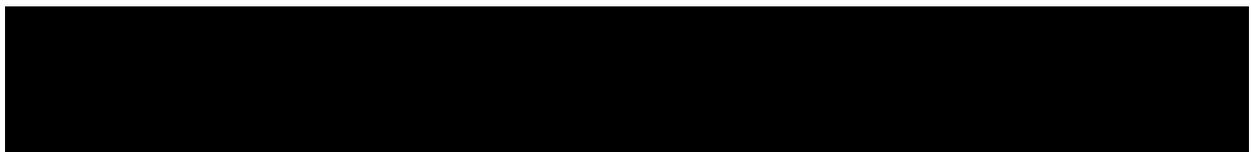
- the present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

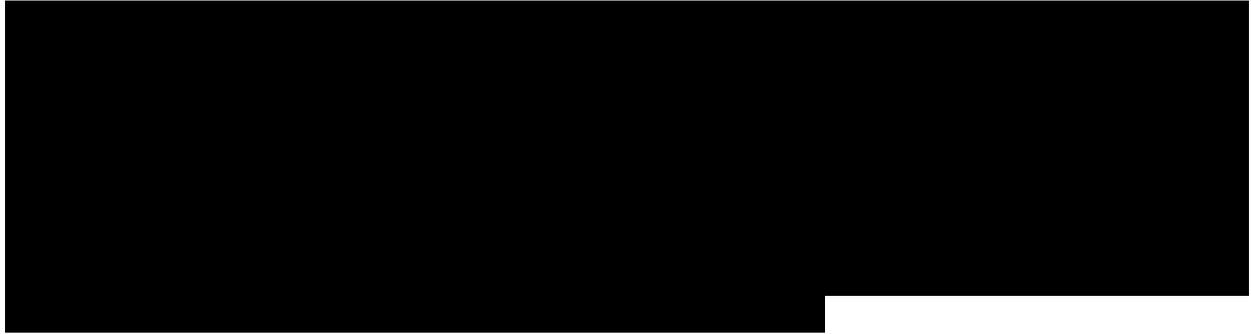
- the present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction;
- one or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership are substantially protected from any risk of loss from the partnership's activities or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;
- substantially all of the partners are related to one another;
- partnership items are allocated in compliance with the literal language of Treas. Reg. §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations;
- the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained by the contributing partner; or
- the benefits and burdens of ownership of partnership property are in substantial part shifted to the distributee partner before or after the property is actually distributed to the distributee partner.

Treas. Reg. § 1.701-2(c)(1) through (7).

Based on the pertinent facts and circumstances, the limited liability company was formed or availed of in connection with the expansion, remodeling, and construction of the hospital and clinic. The principal purpose of the transaction was *not* to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. Accordingly, the Commissioner cannot rely on the anti-abuse regulations set forth in Treas. Reg. § 1.701-2 to recast the transaction for federal tax purposes.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:





Please call if you have any further questions.

By: _____
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