Office of Chief Counsel
Internal Revenue Service
memorandum

CC:PSI:B03:
POSTF-145899-05
Number: **200650014**
Release Date: 12/15/2006

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 732.02-00, 701.01-00

date: September 07, 2006

to: Kelly Davidson, Attorney Advisor
John Duncan, Attorney Advisor
Large & Mid-Size Business

from: Christine Ellison, Chief, Branch 3
(Passthroughs & Special Industries)

---

subject: Application of §§ 731 and 732 to property acquired by a partnership solely for purposes of distribution in liquidation to a retiring partner

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Partnership =

Taxpayer =

LLC =

State X =

State Y =

$a =

$b =

$c =

$d =

$e	=
$f	=
$g	=
$h	=
$i	=
$j	=
z	=
Date 1	=
Date 2	=
Year 1	=
Year 2	=
A	=
B	=

ISSUE

Whether a distribution purportedly in redemption of Taxpayer's interest in Partnership included the State Y house purchased by Partnership.

CONCLUSION

The non-recognition provision of § 731 and substituted basis rule of § 732(b) do not apply when a partnership acquires residential real estate that has no relation to a partnership's business activities, solely for purposes of immediately distributing the real estate to a partner in liquidation.

FACTS

Partnership owned a large parcel of (parcel) in State X. Partnership was also an obligor on several promissory notes secured by deeds of trust encumbering certain portions of Partnership's parcel.

Taxpayer held a total of z percent interest in Partnership directly and indirectly through various trusts. The majority of the partnership interests were held by members of Taxpayer's family and related entities.

Due to ongoing disagreements among the partners, most of the partners (the exiting partners) in Partnership, including Taxpayer, liquidated their interests in Partnership leaving A and A's immediate family (the remaining partners) in control of Partnership. The remaining partners' interests in Partnership increased proportionately as a result of the liquidation of the exiting partners' interests.

The liquidation of Taxpayer's partnership interest was specifically outlined in a redemption agreement. The redemption agreement provided for the purchase and distribution in redemption to Taxpayer of a house in State Y. Specifically, the redemption agreement provided:

> All amounts paid in excess of $a to acquire the [State Y house] as set forth in the Final Closing Statement for the acquisition of the [State Y house] are referred to herein as the "Excess Amount." [Taxpayer] shall be responsible to take out a new loan against the [State Y house] sufficient in amount to repay [Partnership] the Excess Amount (the "New Loan"). [Partnership] and [Taxpayer] acknowledge and agree to treat the distribution of the Real Property to [Taxpayer] by the nominee of [Partnership] hereunder as a distribution of property other than cash by a partnership to a partner pursuant to I.R.C. § 731. [Partnership] shall nominate [LLC], a [State Y] limited liability company that is wholly owned by [Partnership] and treated as a disregarded entity under Treas. Reg. § 301.7701-3 (the "Nominated Purchaser"). [Taxpayer] shall pay all costs and expenses associated with the formation of the Nominated Purchaser. The Nominated Purchaser shall acquire the [State Y house] at the First Closing on behalf of [Partnership]. The Nominated Purchaser on behalf of [Partnership] shall distribute the [State Y house] to [Taxpayer] upon funding of the New Loan within sixty (60) days after the First Closing ("Extension Period") conditioned upon the Nominated Purchaser receiving the Excess Amount plus all other costs associated with the ownership of the [State Y house] by the Nominated Purchaser including all costs of property and casualty insurance and general liability insurance, in such amount and from an insurance company reasonably approved by [Partnership]. It is the intent of the parties that Nominated Purchaser not be responsible for greater than $a in connection with the purchase, ownership, and subsequent transfer of the [State Y house] to [Taxpayer]. [Taxpayer] shall not have any rights to possession of the [State Y house] until the [State Y house] has been distributed by the Nominated Purchaser in accordance with this Section. If for any reason the New Loan does not close within the Extension Period, [Taxpayer] will forfeit all rights to receive the [State Y house], and in lieu of agrees as follows: The

> Nominated Purchaser shall sell the [State Y house] as soon as reasonably possible after the end of the Extension Period. Upon sale, the net proceeds and costs related thereto shall be allocated and disbursed as follows: [B] Loan plus accrued interest will be paid in full directly from the sale escrow. [Partnership] and the Nominated Purchaser shall retain $b from the sale escrow as liquidated damages, and [B] shall receive $b as additional contingent interest on the [B] Loan. The net proceeds from the sale of the [State Y house] will be paid to [Taxpayer] by the Nominated Purchaser on behalf of [Partnership] for the redemption of the [Taxpayer] Partnership Interest. …

To transfer the State Y house to Taxpayer, the following occurred. First, Partnership formed an LLC. Next, on Date 1, Year 1, the LLC purchased the State Y house for $c. The consideration that LLC used to purchase the State Y house consisted of $d cash loaned by B, a partner who was also to be redeemed under the redemption agreement, and $j cash of LLC or Partnership. Pursuant to the terms of the redemption agreement, in Date 2 of Year 2, Taxpayer took out a $e mortgage against the State Y house and used the proceeds to pay LLC. LLC then repaid B. Simultaneously, LLC transferred the State Y house to Taxpayer by grant deed.

Taxpayer recognized $f in income on account of the money received in excess of Taxpayer's basis in Partnership. This amount consists of $g I.R.C. § 752(b) debt relief deemed distribution, $h total cash payments distributed on Date 2, Year 2, and $i in later distributions. Taxpayer claims that the total distribution of money does not include the fair market value of the State Y house because, under I.R.C. § 731(a)(1) and § 1.731-1(a)(1)(i), in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. Taxpayer claims that, under I.R.C. § 732(b) and § 1.732-1(b), if a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of the partner's interest in the partnership reduced by the amount of any money distributed to the partner in the same transaction. Taxpayer's basis in the partnership interest was zero as of Date 2, Year 2, and Taxpayer claims a zero basis in the State Y house.

LAW AND ANALYSIS

Section 731 provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and that any gain so recognized shall be considered as gain from the sale or exchange of the partnership interest of the distributee partner.

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(a) Distribution not a distribution of partnership property

The Internal Revenue Code of 1954 adopted comprehensive partnership tax rules in subchapter K. In the legislative history to the provisions relating to contributions and distributions, the Ways and Means Committee of the House of Representatives explained the carry-over basis rules of §§ 721 and 731:

> The proposed rules for contributions to, and distributions by, a partnership, in effect, permit the tax-free transfer of property into or out of a partnership. Generally, speaking, the basis of property remains unchanged through the formation and dissolution of a partnership. This relatively simple approach is made possible by reducing the basis of the distributee's interest in the partnership by the basis of the *distributed partnership property* and by the recognition of gain or loss in the case of certain distributions. H. Rep. No. 1337, at 69 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4096. (Emphasis added).

Similarly, the Senate Finance Committee explained:

> These new distribution rules limit quite narrowly the area in which gain or loss is recognized upon a distribution. Gain is to be recognized only where the money distributed is in excess of a partner's basis for his interest; and loss is to be recognized in the case of a liquidating distribution where only money, inventory items and unrealized receivables are distributed and their basis to the partnership is less than the basis of the partner's interest. These rules, combined with the nonrecognition of gain or loss upon contribution of property to a partnership, *will remove deterrents to property being moved in and out of partnerships as business reasons dictate*. S. Rep. No. 1622, at 96 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4729. (Emphasis added).

Under the facts presented in this case, a carry-over basis is not appropriate for a unique parcel of residential property that apparently was selected by the distributee, acquired by the partnership immediately before the distribution, solely for the purpose of the distribution, and was unrelated to the partnership's business activities.

Moreover, the facts are consistent with a finding that Partnership was never the owner of the State Y house for federal tax purposes. A significant portion of the purchase price for the State Y house was provided by funds borrowed from Taxpayer's relative (relative), a loan that was immediately repaid by Taxpayer. The redemption agreement provided that, if Taxpayer did not pay all of the expenses associated with the transaction and repay Partnership the amount of the purchase price in excess of $a within a stated period of time, the State Y house would be sold, Partnership reimbursed for expenses and provided an amount in liquidated damages, the relative lender repaid, and the remaining funds distributed to Taxpayer.

The facts in this case are consistent with a finding that the State Y house was acquired and held for the account of Taxpayer and became property of the Taxpayer at the time it was acquired for Taxpayer by the Partnership. See Rev. Rul. 55-39, 1955-1 C.B. 403 (investment by partnership of partner's contributed capital in securities of partner's choice and for partner's own account constituted a withdrawal of capital from the partnership and an investment by partner in securities purchased, resulting in reduction in partner's partnership interest). When Partnership purchased the State Y house for Taxpayer, it in effect distributed cash to Taxpayer in the amount of the $a, the amount used by Partnership to acquire the State Y house. The subsequent purported distribution of the State Y house to Partner is not a distribution of partnership property under § 731. See id.

We conclude that §§ 731 and 732 do not apply to the purported distribution of the State Y house to Taxpayer because the distribution was not a distribution of Partnership property.

(b) Partnership Anti-Abuse Rules

Alternatively, if the State Y house was properly considered to be property of Partnership, the transaction should be recast in accordance with the regulations under § 1.701-2 (the anti-abuse rules). The anti-abuse rules provide that 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. § 1.701-2(b).

Section 1.701-2(a) provides that the following requirements are implicit in the intent of subchapter K: (1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose; (2) The form of each partnership transaction must be respected under substance over form principles; and (3) Except as otherwise provided in paragraph (a)(3), 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 (collectively, proper reflection of income).

Section 1.701-2(c) describes certain of the factors that may be taken into account in determining 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. Three of those factors are: (i) 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, (ii) 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, and (iii) substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another.

With respect to these three factors, if the Taxpayer purchased the State Y house directly, Taxpayer's tax liability would have been greater as Taxpayer would have to recognize an additional $a of income or gain. In addition, through the use of the subchapter K rules, Taxpayer's tax liability is substantially less than would have been the case if the steps of the transaction were integrated to treat Taxpayer as receiving a distribution of $a cash from Partnership, and then purchasing the State Y house. Furthermore, all of the partners in Partnership are related (directly or indirectly) to one another.

To liquidate Taxpayer's interest in Partnership, Partnership made a purported distribution to Taxpayer of the fair market value of the State Y house (in addition to $g debt relief and $h total cash payments) to Taxpayer for the value of Taxpayer's interests in Partnership. Because this exceeded Taxpayer's basis in Partnership, Taxpayer would have had to recognize an additional $a of income or gain if paid directly to Taxpayer. By attempting to characterize the distribution of the fair market value of the State Y house as a distribution of property other than money, Taxpayer and Partnership used the rules of subchapter K inappropriately in a manner that attempted to eliminate $a of income or gain with respect to Taxpayer.

We conclude that the transaction should be recast in accordance with the anti-abuse rules of § 1.701-2 as a distribution of $a in cash to Taxpayer, which Taxpayer then used, in addition to funds provided directly (albeit temporarily) by B, to acquire the State Y house.

(c) Step Transaction and Economic Substance

Finally, this transaction may be attacked under judicial doctrines of step transaction and a lack of economic substance.

A transaction may be recast to reflect its true nature under the step transaction doctrine. Andantech LLC v. Comm'r, T.C. Memo. 202-07, aff'd in part and remanded in part, 331 F.3d 975 (D.C. Cir. 2003); True v. U.S., 190 F.3d 1165, 1176-77 (10th Cir. 1999). Under the step transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for "no other purpose than to avoid tax." Del Commercial Props., Inc. v. Comm'r, 251 F.3d 210, 213-214 (D.C. Cir. 2001), cert. Denied, 534 U.S. 1104 (2002). As described in Smith v. Comm'r, 78 T.C. 350, 389 (1982), aff'd without op., 820 F.3d 1220 (4th Cir. 1987):

> The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged. See Gregory v. Helvering, 293 U.S. 465 (1935).

The existence of business purposes and economic effects for the individual steps in a complex series of transactions does not preclude application of the step transaction doctrine. True, supra.

There are three alternative tests for deciding whether the step transaction doctrine applies in a particular situation, namely: (1) if at the time the first step was entered into, there was a binding commitment to undertake the later step(s) ("binding commitment test"), (2) if separate steps constitute prearranged parts of a single transaction intended to reach an end result ("end result test"), or (3) if separate steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the series of steps ("interdependence test"). See Associated Wholesale Grocers, Inc. v. Comm'r, 927 F.2d 1517 (10^{th} Cir. 1991).

Each step taken by the parties (the formation of the LLC, the loan to purchase the house, the purchase of the house, and the subsequent transfer of the house to Taxpayer upon liquidation of her partnership interest) were mere transitory steps toward the ultimate goal of transferring $a of value to Taxpayer in the form of a personal residence, without gain recognition. The individual steps were prearranged in a binding contract and had no independent business purpose. Under step transaction principles, the acquisition of the State Y house by Partnership and its distribution to Taxpayer should be disregarded.

Moreover, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction in order to be respected for federal tax purposes. See Gregory v. Helvering, 293 U.S. 465 (1935). If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yosha v. Comm'r, 861 F.2d 494, 498-99 (7^{th} Cir. 1988), aff'g Glass v. Comm'r, 87 T.C. 1087 (1986); Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966), aff'g 44 T.C. 284 (1965); ACM Partnership v. Comm'r, T.C. Memo. 1997-115, aff'd in part and rev'd in part, 157 F.3d 231 (3d Cir. 1998).

Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). In determining whether a transaction has economic substance, both the objective economic substance of the transaction and the subjective business motivation of the taxpayer must be determined. The objective economic substance of the transaction and the involved parties' subjective business motivations must be determined. ACM Partnership v. Comm'r, 157 F.3d 231, 247 (3rd Cir. 1998), cert. denied, 526 U.S. 1017 (1999); Casebeer v. Comm'r, 909 F.2d 1360, 1363 (9th Cir. 1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction has sufficient substance, apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363.

The objective standard is whether a transaction has any practical economic effects aside from the creation of tax losses and/or the transaction was devoid of economic substance because it did not appreciably affect the taxpayer's non-tax beneficial interest. ACM Partnership, 157 F.3d at 247. Offsetting legal obligations or circular cash flows may effectively eliminate any real economic significance of a transaction. Knetsch v. United States, 364 U.S. 361 (1960).

To analyze a transaction's economic aspects, courts look to whether the taxpayer had a non-tax business purpose for the transaction and a reasonable expectation of profit. See ACM Partnership, 157 F.3d at 252-54; see also Coltec Industries v. United States, ___ F.3d___No. 05-5111 (Fed. Cir. July 2006) and Black & Decker v. U.S., 436 F.3d 431 (4th Cir. 2006) (focus is on the transaction creating tax benefits not overall business purpose of taxpayer). The determination turns on whether the transaction is rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it are to be evaluated in accord with commercial practices in the relevant industry. Cherin v. Comm'r, 89 T.C. 986, 993-94 (1987). A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs. Yosha v. Comm'r, 861 F.3d 494, 498-99 (7th Cir. 1988).

Objectively, Partnership's purchase of the State Y house and immediate distribution to Taxpayer had no practical economic effects aside from the avoidance of gain recognition. The acquisition of the State Y house was structured to avoid any potential gain or loss by Partnership on the transaction. Taxpayer was apparently entitled to $a of value from Partnership and received $a of value. The use of a residential property acquired solely for the purpose of avoiding gain recognition on that $a of value had no objective economic effect.

Subjectively, Partnership and Taxpayer clearly had no intent to profit economically from the transaction. It is evident from the terms of the redemption agreement that the State Y house was to be distributed by LLC.to Taxpayer immediately upon Taxpayer obtaining a loan (within 60 days) to fund the purchase. In addition, LLC would be reimbursed all costs and expenses associated with the purchase of the State Y house. If Taxpayer could not obtain the necessary loan within

60 days, LLC would immediately sell the State Y house. It is difficult to conclude an intent to profit from the purchase and sale of a house within a brief 60 day period. Clearly, the sole purpose of the transaction was to obtain tax benefits that would not be available otherwise.

We conclude that under step transaction principles, the acquisition of the State Y house by Partnership and its distribution to Taxpayer should be disregarded. We also conclude that the acquisition of the State Y house by Partnership and the distribution of the house to Taxpayer lacked economic substance and are unnecessary steps taken solely to achieve tax benefits.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call if you have any further questions.