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"Partnership Reimbursement of Preformation Expenses: Tax-Free Cash"

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Introduction

Consider the following hypothetical situation. Joe bought a tract of land in late 1999 for \$300,000. In early 2001, Joe and Mark form the Get Rich Quick Partnership (GRQP) and Joe contributes to GRQP the land, which is now worth \$1 million,¹ as his capital contribution for a 50% partnership interest. Mark obtains his 50% interest in GRQP by contributing \$500,000 of cash and agreeing to obtain financing to build apartments on the land. Because Joe is relatively land rich but cash poor, they also agree that after the loan commitment is obtained and at least \$500,000 is drawn down under the loan, GRQP will distribute \$500,000 to Joe. Shortly thereafter, a loan commitment for \$10 million is obtained, \$500,000 is drawn down and GRQP distributes the \$500,000 to Joe.² Under the applicable tracing rules of the Treasury regulations,³ the \$500,000 is considered to have come from Mark's contribution.

Those of us with gray hair⁴ may remember the days when the distribution of the \$500,000 would probably be a nontaxable distribution to Joe, merely reducing the basis of his interest in GRQP.⁵ Such was the case before April 1, 1984, the effective date⁶ of Section 707(a)(2)(B)⁷ enacted as part of the Deficit Reduction Act of 1984.⁸ Although before that date the Internal Revenue Service attempted in vain to use Treasury regulations to treat Joe's contribution as a taxable transaction,⁹ clever taxpayers and their malevolent advisors had repulsed the Internal Revenue Service's attacks quite soundly in court.

Congressional Response

Due to these defeats, the Treasury convinced Congress to amend Section 707 by adding the "disguised sale rule."¹¹ The disguised sale rule is in Section 707(a)(2)(B) which provides:[i]f (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers, described in clauses (i) and (ii), when viewed together are properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction described in paragraph (i) of [Section 707(a)] or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.¹²

The disguised sale rule is fairly complex in its operation.¹³ A number of special rules apply, for example, to guaranteed payments, preferred returns, operating cash flow distributions¹⁴ and liabilities.¹⁵ The exception upon which this article focuses is a sometimes forgotten exception to the disguised sale rule called "reimbursement of preformation expenditures."¹⁶

Applicable Regulations

Treasury Regulation Section 1.707-3(a)(1) provides that, except as otherwise provided in applicable regulations, if a transfer of property by a partner to a partnership and one or more transfers of money or other consideration by the partnership to that partner are described in Section 1.707-3(b)(1), the transfers are treated as a sale of property, in whole or in part, to the partnership.

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Treasury Regulation Section 1.707-3(b)(1) provides that a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances (i) the transfer of money or other consideration would not have been made but for the transfer of property; and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

Treasury Regulation Section 1.707-3(c)(1) provides 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.

The "reimbursement of preformation expenditures" exception is in Treasury Regulation Section 1.707-4(d) which provides that a transfer of money or other consideration by a partnership to a partner is not treated as part of a sale of property by the partner to the partnership under Treasury Regulation Section 1.707-3(a) 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 (i) partnership organization and syndication costs described in Section 709; or (ii) property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20% of the fair market value of such property at the time of the contribution. However, the 20% of fair market value limitation does not apply if the fair market value of the contributed property does not exceed 120% of the partner's adjusted basis in the contributed property at the time of contribution.

Application to Example.

Looking back at our example, Joe incurred \$300,000 of capital expenditures (*i.e.*, his cost) with respect to his contributed land within two years of its contribution to GRQP. However, under the disguised sale rule, because Joe's property has a fair market value (\$1 million) in excess of 120% of its basis (120% of \$300,000 or \$360,000), he may receive a distribution of only 20% of the fair market value (20% of \$1 million or \$200,000) tax-deferred under the preformation expenditure exception. The remaining portion of the distribution (\$300,000) will be treated as having been received in exchange for a sale of a portion of the land contributed. Joe will be treated as having sold \$300,000/\$1,000,000 of the land or 30%. The regulations do not indicate whether, in computing the basis to be allocated to the 30% portion sold, the original basis must first be reduced by the reimbursed preformation expenditure (*i.e.*, the basis of the land deemed sold is 30% of the net basis (\$300,000 less \$200,000 or \$100,000) or \$30,000) or not (if not, the basis would be 30% of \$300,000 or \$90,000).

If Joe had acquired his property entirely for a \$300,000 debt, he may have been able to receive \$200,000 of cash (tax-deferred) under the exception for reimbursement of preformation expenditures and also have the GRQP assume and pay the \$300,000 without adverse tax consequences pursuant to another exception.¹⁷ Under this hypothetical, Joe would not have received a distribution in excess of basis under Section 731 of the Code because his basis of \$550,000 (\$300,000 land cost plus \$250,000 share of liabilities) exceeds the \$500,000 distribution to him (\$200,000 cash and \$300,000 deemed distribution resulting from the debt reduction). Because Joe's capital account is lower than Mark's and because Joe contributed appreciated property to the partnership, Joe and Mark will not be in identical positions with respect to future allocations under Section 704 - an analysis that is beyond the scope of this article.

This technique could be used as a source of financing. For example, a cash starved real estate investment trust ("REIT") may contribute newly improved property to a partnership having excess funds and receive a tax-deferred cash distribution.¹⁸ Alternatively, by using this technique, a cash-rich REIT may acquire properties from property-rich investors seeking tax-deferred cash.

¹ Joe is extremely perspicacious in discovering real estate poised for rapid appreciation.

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2 That this is a “hypothetical” situation explains how Mark could find a lender that would allow \$500,000 to be distributed to Joe and not used for improvements.

3 Treas. Reg. § 1.163-8T.

4 And perhaps those with no hair.

5 Before enactment of the disguised sale rules of Section 707(a)(2)(B), the following would have been the analysis. Joe would not recognize gain on the contribution of the land to GRQP because Section 721(a) provides that “[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.” Joe would have a basis in his partnership interest of his land cost plus his one-half share of GRQP’s liabilities of \$500,000 (assuming only \$500,000 of the \$10,000,000 loan had been drawn down); i.e., \$300,000 plus \$250,000 or \$550,000 - conveniently greater than the cash distribution. See I.R.C. §§ 722 and 752(a). Section 731(a)(1) provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized to the partner, except to the extent that any money distributed exceeds the adjusted basis of the partner’s interest in the partnership immediately before the distribution. But see the provisions of Treas. Reg. §§ 1.721-1(a) and 1.731-1(c)(3) discussed in footnote 9 infra.

6 Does anybody really believe that an effective date of April Fool’s Day was merely coincidental?

7 Unless otherwise noted, all section references are to the Internal Revenue Code of 1986.

8 Also known as the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

9 Treas. Reg. § 1.721-1(a) provides, in part: Section 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by Section 707. Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See paragraph (c)(3) of § 1.731-1. Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under Section 707 rather than as a contribution under Section 721.

Treas. Reg. § 1.731-1(c)(3) provides:

If there is a contribution of property to a partnership and within a short period:

Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or

After such contribution the contributed property is distributed to another partner, such distribution may not fall within the scope of Section 731. Section 731 does not apply to the distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property.

10 *Otey v. Commissioner*, 70 T.C. 312 (1978), aff’d per curiam, 634 F.2d 1046 (1980). As opposed to Joe and Mark, Mr. Otey inherited his tract of land, and his partner made no capital contribution. The distribution was funded entirely from loan proceeds. However, in our example we traced the source of the cash distribution to Mark’s cash

11 The applicable Senate Finance Committee Report provides: In the case of disguised sales, the committee is concerned that taxpayers have deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed (or preceded) by a related partnership distribution. Although Treasury regulations provide that the substance of the transaction should govern, court decisions have allowed tax-free treatment in cases which are economically indistinguishable from sales of property to a partnership or another partner. The committee

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believes that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance.

Deficit Reduction Tax Bill of 1984, Explanation of the Senate Finance Committee, 71 Fed. Tax Rep. (CCH) 16,225 (issued April 2, 1984), reprinted in 1985 U.S.L.C.A.N. 697, 884. If tax was being “avoided,” the Treasury apparently believed it must convince Congress that something had to be done, even though the tax on the distribution was really only being deferred.

12 The related Treasury regulations are Treas. Reg. § 1.707-3 through Treas. Reg. § 1.707-6.

13 The original publication of the related final Treasury regulations in 1992, including the preamble, consumed 17 (three columned) pages of the Internal Revenue Cumulative Bulletin. See T.D. 8349, 1992-2 C.B. 126. This is another indication that tax simplification is not a top priority when income taxes are being “avoided.”

14 Treas. Reg. § 1.707-4.

15 Treas. Reg. § 1.707-5.

16 Treas. Reg. § 1.707-4(d).

17 This involves application of the “qualified liability” rules of Treas. Reg. § 1.707-5(a)(5), not the subject of this article. However, in summary, Treas. Reg. § 1.707-5(a)(5)(i) provides that “[i]f a transfer of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership’s assumption of or taking subject to a qualified liability in connection with a transfer of property is not treated as part of a sale.” Treas. Reg. § 1.707-5(a)(6) provides several alternative methods under which a liability may be qualified. Joe’s liability would be qualified under Treas. Reg. § 1.707-5(a)(6)(C), as a liability allocable under the rules of Treas. Reg. § 1.163-8T to capital expenditures with respect to the property. Interestingly, there is no provision that prevents the application of both Treas. Reg. § 1.707-4(d) and Treas. Reg. § 1.707-5(a)(5) to the same conveyance. Thus, Joe could receive \$200,000 tax-deferred under Treas. Reg. § 1.707-4(d) and have GRQP assume the full \$300,000 liability under Treas. Reg. § 1.707-5(a)(5)(i).

18 This is illustrated in PLR 9829027 (Apr. 17, 1998). See also PLR 199914006 (Dec. 23, 1998).