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House of Cards: IRS Partnership Holding Alarming, But Facts Are Extreme

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Generally, a distribution by a partnership to a partner of property other than money or marketable securities is not a taxable transaction. However, in a recent Chief Counsel Advice (the "Advice"), the Internal Revenue Service treated the liquidating distribution of a house by a partnership to a partner as a taxable distribution of money.[1] Although this holding is alarming at first glance, its scope and import are likely limited as the Advice responded to a particularly egregious set of facts.

The Facts of the Advice

Taxpayer, his family members, and related entities owned a majority of the interests in the partnership. Due to ongoing disagreements among the partners of the partnership, the taxpayer, and most of the other partners agreed to liquidate their interests in the partnership. The partnership agreed to liquidate the taxpayer's interest in the partnership by distributing the house (not currently owned by the partnership) to the taxpayer.

To transfer the house to the taxpayer, the partnership formed an LLC that purchased the house with money loaned to the LLC by a relative ("X") of the taxpayer (who was also a partner to be redeemed in the liquidation). The redemption agreement provided that the taxpayer was responsible for all costs and expenses associated with forming the LLC, as well as all property, casualty and general liability insurance with respect to the house. Taxpayer was obligated to secure a loan within 60 days of the LLC's acquisition of the house with which the taxpayer was to repay the LLC for the cost of acquiring the house. In the event the taxpayer could not secure a loan within 60 days, the parties agreed that the LLC would sell the house, pay expenses, retain liquidated damages and distribute the net proceeds to the taxpayer, in liquidation of the taxpayer's interest in the partnership. The taxpayer succeeded in obtaining a loan secured by a mortgage against the house, used the proceeds to repay the LLC, and the LLC repaid X. Simultaneously, the LLC transferred the house to the taxpayer.

The Service's Conclusion

In the Advice, the Service concluded that the distribution consisted of a distribution of money to the taxpayer in an amount equal to the fair market value of the house. The Service based its position on three alternate theories: (i) that there was no distribution of "partnership property"; (ii) that the transactions violated and should be recast under the partnership anti-abuse rule of Regulation section 1.701-2; and (iii) that the transaction should be recast in accordance with its economic substance under the step transaction doctrine.

Under the first (quasi-agency) theory, the Service argued that the facts were consistent with a finding that the partnership was never the owner of the house for federal tax purposes. The Service found that the house was selected by the taxpayer and that the partnership acquired the house (an asset unrelated to the partnership's business) solely for the purpose of distribution. Moreover, the consideration used to purchase the house was borrowed from a relative of the taxpayer and repaid by the taxpayer. Based on these findings, the Service concluded that, in essence, the house became the property of the taxpayer at the time it was acquired by the partnership for the taxpayer. Accordingly, the Service recast the transaction as a distribution of cash to the taxpayer in an amount equal to the amount of equity used by the partnership to acquire the house, followed by an acquisition of the house by the taxpayer with the distributed funds.

Under the second theory, the Service asserted that, because a principal purpose of the transaction was 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 Service had the authority to recast the transaction for federal tax purposes under the partnership anti-abuse rule of Regulation section 1.701-2(b). The Service found

three factors indicating that such a principal purpose existed with respect to the facts at hand: (i) the present value of the partners' aggregate federal tax liability was substantially less than it would have been if the partners had owned the partnership's assets and conducted the partnership's activities directly; (ii) the present value of the partners' aggregate federal tax liability was substantially less than would have been the case if the purportedly separate transactions designed to achieve a particular result were integrated and treated as steps in a single transaction; and (iii) substantially all of the partners were related (directly or indirectly) to one another. Upon concluding that the transaction violated the partnership anti-abuse rule, the Service again recast the transaction as a distribution of money to the taxpayer, which the taxpayer then used to acquire the house.

Lastly, the Service concluded that the acquisition of the house by the partnership and its distribution to taxpayer lacked economic substance and violated step transaction principles. The Service found 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) to be mere transitory steps toward the ultimate goal of transferring value to the taxpayer in the form of a personal residence, without gain recognition. In analyzing the economic substance of the transactions, the Service found that the partnership and the taxpayer had no intent to profit economically from the transaction noting that "[i]t is difficult to conclude an intent to profit from the purchase and sale of a house within a brief 60 day period."

Analysis

Viewed broadly, the Advice could be interpreted as holding that, in order for a distribution of partnership property by a partnership to a partner to qualify for nonrecognition under Code section 731(a), the distributed property must be related to the partnership's business activities. However, there is no indication in the Code, the Regulations, or the legislative history of the relevant provisions that the distributed property must have any relation to the business activities of the partnership. Moreover, in its application of the anti-abuse rule, the Advice concludes that the transaction had a principal purpose to substantially reduce the partners' tax liability in a manner "inconsistent with the intent of subchapter K." Yet, subchapter K itself provides that a distribution of property from a partnership to a partner is not generally a taxable event. Where exactly does the intent of subchapter K end and the abuse begin?

In connection with partnership redemptions and dissolutions it has been common practice for the redeemed partners to determine what properties they would be willing to accept in redemption of their interests and there has never been any authority for the proposition that the redeemed property must be property that has historically been owned by the partnership.

The facts in the Advice are about as "bad" as one could imagine. The distributed asset was not only unrelated to the partnership's business, but it was an asset of a personal nature (a personal residence). The taxpayer seemingly orchestrated the transaction. The taxpayer was responsible for all expenses and insurance with respect to the house, even for the short period of time when the partnership was the actual owner of the house. When these facts are taken into account, the Advice may be interpreted to apply only to situations where a partner has such control over and rights to the distributed property from the moment of acquisition by the partnership as to attribute the acquisition of the distributed property to the distributee partner.

While the conclusion in the Advice may not be unreasonable given the extreme facts, the Service's analysis, which brushes aside much of subchapter K, seems questionable and the discussion in the Advice reads more like advocacy than a balanced weighing of issues. Practitioners are now wondering whether this advice embodies a warning to those practicing highly aggressive tax planning or is rather a fundamental challenge to the way the partnership taxation rules are applied.

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[1] Chief Counsel Advice 200650014. A Chief Counsel Advice is written advice by the Internal Revenue Service's Office of Chief Counsel directed to other IRS employees, but does not necessarily reflect the conclusion that a court would reach.