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Dividing a Real Estate Empire: The Mixing Bowl Alternative

By Stephen M. Breitstone, Esq.
and Mark E. Wilensky, Esq.
Meltzer, Lippe, Goldstein & Breitstone, LLP
Mineola, New York

INTRODUCTION

This article will explore methods of dividing real estate portfolios using a structure commonly referred to as a ''mixing bowl.'' A common fact pattern is where there are multiple commonly owned partnerships or limited liability companies taxed as partnerships (referred to hereafter as a ''partnership'' or ''partnerships'') each holding one or more properties. One method of separating the partners would be to undertake multiple ''drop and swap'' transactions whereby properties are distributed into tenancies in common in liquidation of the partnerships. The partners may then be able to exchange the tenancies in common so that each partner is left with one or more entire properties. Depending upon the facts and circumstances, there may be certain tax risks associated with this form of transaction. While the state of the law seems to be generally favorable to the ''drop and swap'' technique, one must proceed with caution in light of the historical IRS rulings in the subchapter C arena, the inclusion in 2008 of questions 13 and 14 in Form 1065,[1] which suggest the IRS is on the lookout for these transactions, and the overtly aggressive audit policies of states such as California and New York which appear directly to target ''drop and swap'' transactions.

An alternative to the ''drop and swap'' technique is the ''mixing bowl'' method. The mixing bowl method would entail the contribution of the multiple properties (or interests in properties or entities holding property) into a master holding company (the ''mixing bowl partnership''). After an appropriate period of time the mixing bowl partnership may be liquidated with entire properties being distributed to each of the former partners — so that they may go their separate ways. There are limitations to the ability to effect this type of transaction including the disguised sale rules of §707(a)(1) and the anti-mixing bowl rules of §704(c)(1)(B) and §737.[2] In general, the anti-mixing bowl provisions require the mixing bowl partnership to hold the contributed assets for a minimum of seven years — which may seem like an eternity to partners looking to separate. However, in appropriate circumstances, that period may be reduced significantly. A detailed and technical analysis of these provisions follows. The discussion in the latter portion of this article discusses how to minimize the holding period.

NAVIGATING THE DISGUISED SALE PROVISIONS

Assuming the ultimate objective of the mixing bowl is to liquidate the mixing bowl partnership and divide the properties or interests in properties among its members, the first question that arises is whether there has been either, in substance, a taxable exchange of the partners' interests in the various real estate partnerships or a disguised sale of property between the partners and the mixing bowl partnership. If the transfers of property to the mixing bowl partnership and subsequent liquidation occurred pursuant to a prearranged plan relatively close in time, the IRS could look to its authority under §731 and §707(a)(1) to treat the transfers to and from the mixing bowl part-

[1] Question 13 asks whether ''[d]uring the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than disregarded entities wholly-owned by the partnership throughout the tax year.)''

Question 14 asks whether ''At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?''

[2] Unless otherwise stated, all section references herein are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder.

nership as, in substance, an exchange by the partners of their interests in the real estate partnerships. Alternatively, if the facts and circumstances surrounding the transfers of property to the mixing bowl partnership and the subsequent liquidation suggested that the partners were not risking their capital to the entrepreneurial risks of partnership operations, the IRS could look to its authority under §707(a)(2)(B) and the regulations thereunder to treat the transfers as a disguised sale of property by the partners to the partnership.

Limitations Under §721 and §731 on Tax-Free Transfers to and from Partnerships

One of the characteristics of a partnership for tax purposes is that contributions of property to, and distributions of property by, a partnership are afforded nonrecognition treatment under subchapter K of the Internal Revenue Code. This feature makes partnerships an excellent vehicle for transferring the economics of property by and among partners without causing recognition of gain and in most instances loss. Thus, §721(a) provides, as a general rule, ''no 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.''

Section 731(a)(1) provides, ''[i]n 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.'' Section 731(a)(2) provides that in the case of a distribution to a partner, ''loss shall not be recognized to such partner, except that upon a liquidation of a partner's interest in a partnership where no property other than money, ''unrealized receivables'' (as defined in §751(c)) and ''inventory'' (as defined in §751(d)) is distributed to such partner.'' Section 731(b) provides, ''no gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.''

Section 707(a)(1) has long provided an exception to the nonrecognition principles of §721 and §731 where a partner was not acting in the capacity as a partner. Section 707(a)(1) provides, ''[i]f a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.''

Treasury regulations under §721 and §731 have long held that those sections do not apply to a transaction that was, in substance, a sale of property between partners or between a partner and the partnership. Reg. §1.721-1(a), substantially identical since its initial promulgation in 1956, provides:

> 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.

Reg. §1.731-1(c)(3), identical since its initial promulgation in 1956, provides:

> If there is a contribution of property to a partnership and within a short period:
>
> > (i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or
> >
> > (ii) After such contribution the contributed property is distributed to another partner,
>
> such distribution may not fall within the scope of §731. Section 731 does not apply to a 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.

Reg. §1.707-1(a), identical since its initial promulgation in 1956, provides:

> A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. . . . In all cases, the substance of the transaction will govern rather than its form. See paragraph (c)(3) of §1.731-1.

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In Rev. Rul. 57-200,[3] the IRS treated the contribution of corporate stock by the partners to a partnership followed immediately thereafter by a distribution of the stock to the partners in liquidation of their interests in the partnership as a taxable exchange of property between the partners. In the ruling, A and B were individuals who each owned a one-half interest in a partnership and one-half interests in corporations X and Y. The partnership had been in existence for several years. A and B desired to sever all of their business relations and, for the purpose of accomplishing a complete severance, contributed all of their interests in corporations X and Y to the partnership. Immediately thereafter, the partnership was terminated, with certain of the partnership assets and all of the stock in corporation X being distributed to A and the remainder of the partnership assets and all of the stock in corporation Y being distributed to B.

The IRS, on the authority of Reg. §1.731-1(c)(3), concluded that §731 did not apply to the distributions of corporate stock and that the transfers constituted ''an exchange of property between the partners upon which gain or loss is recognized for Federal income tax purposes.'' According to the IRS, the transfer of stock to the partnership followed by the immediate distribution of the stock to the partners constituted ''steps in an integrated transaction entered into for the purpose of effecting an exchange of the corporate stock interests between the partners without the recognition of gain to the partner or the partnership.''

The IRS's position in Rev. Rul. 57-200 serves as an important reminder that the limitations under regulations to §721 and §731, as well as the later-enacted disguised sale rules, may apply to restrict the ability to transfer property to and from a mixing bowl partnership on a tax-free basis. Nevertheless, prior to the enactment of the current disguised sale provisions in §707(a)(2)(B), taxpayers were, in some cases, successful in challenging the IRS's application of the regulations under §721 and §731 to various transactions involving either contributions of property to a partnership followed by a distribution of cash to the contributing partner, or to contributions of cash to a partnership by new partners followed immediately thereafter by distributions of cash to existing partners.[4] In one of those cases cited in the legislative history to §707(a)(2)(B), *Communications Satellite Corp.*, the Court of Claims held for the taxpayer on whether a transaction was a disguised sale of a partnership interest but, nevertheless, cited Rev. Rul. 57-200 with approval as ''the type of transaction that the regulation [i.e., Reg. §1.731-1(c)(3)] covers.''[5] Accordingly, while courts have not upheld the IRS's application of the ''substance over form'' approach in Reg. §1.707-1(a) and §1.731-1(c)(3) in various contexts, Rev. Rul. 57-200 and the regulations upon which it relies stands as a potential obstacle to taxpayers' use of partnerships and the rules of subchapter K to effectuate a tax-free swap of properties.

That said, as under the disguised sale regulations in Reg. §1.707-3, discussed below, Rev. Rul. 57-200 ought not to apply as long as the transfers to and from the partnership are not close in time and the subsequent distributions of property are subject to entrepreneurial risks of partnership operations. In Rev. Rul. 57-200, most noteworthy, the transfers of stock to the partners occurred immediately after the transfers to the partnership. The holding in Rev. Rul. 57-200 arguably also applies if the transfers occur ''within a short period,'' based on the language in Reg. §1.731-1(c)(3). Nevertheless, transfers of property to and from a partnership ought to be outside the scope of the ruling and Reg. §1.707-1(a) and §1.731-1(c)(3) as long as there is a sufficient duration in time between transfers and the transfers are subject to entrepreneurial risk of partnership operations.

Disguised Sale Regulations Emphasize the Need for Contributed Property to Be Subject to Entrepreneurial Risks of Partnership Operations

Section 707(a)(2)(B), enacted in 1984, provides that ''under regulations prescribed by the Secretary,'' ''If —

> (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 (1) or as a transaction between 2 or more partners act-

[3] 1957-1 C.B. 205.

[4] *See Senate Report to Deficit Reduction Act of 1984*, S. Rep. No. 98-169, citing *Otey v. Commissioner*, 70 T.C. 312 (1978), *aff'd per curiam*, 634 F.2d 1046 (1980); *Communications Satellite Corp. v. United States*, 223 Cl. Ct. 253 (1980); and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983).

[5] *Communications Satellite Corp. v. United States*, n. 6, above.

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ing other than in their capacity as members of the partnership.

Treasury regulations implementing §707(a)(2)(B) with respect to disguised sales of property to partnerships were finalized in 1992. No regulations have been issued with respect to disguised sales of partnership interests. Until the issuance of regulations, the IRS has advised taxpayers that ''the determination of whether a transaction is a disguised sale of a partnership interest under §707(a)(2)(B) is to be made on the basis of the statute and its legislative history.''[6]

Reg. §1.707-3(b)(1) provides:

> 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.[7]

Reg. §1.707-3(b)(2) provides:

> The determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, under paragraph (b)(1) of this section is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the earliest of such transfers are the ones considered in determining whether a sale exists under paragraph (b)(1) of this section.

Factors Suggesting a Disguised Sale

The regulations include a list of facts and circumstances ''that may tend to prove the existence of a sale,'' including:

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the transferor has a legally enforceable right to the subsequent transfer;

(iii) 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 secured;

(iv) 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;

(v) 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;

(vi) 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 (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(vii) 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 (taking into account the income that will be earned from those assets);

(viii) That partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(ix) 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

(x) 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

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[6] Notice 2001-64, 2001-41 I.R.B. 316.

[7] Under the regulations the distribution to a contributing partner of ''reasonable'' guaranteed payments, ''reasonable'' preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures do not give rise to a disguised sale. *See* Reg. §1.707-4(a)–§1.707-4(d).

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consideration transferred by the partnership to the partner.[8]

The list of factors tending to prove the existence of a sale is worth close study. Although the list was not intended to serve as a comprehensive list, courts to date have treated it that way and have analyzed each factor as part of the disguised sale analysis.[9]

The transfer of property by a partner to a partnership within two years of the transfer of money or other consideration by the partnership to the partner (without regard to order) ''are presumed to be a sale of property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.''[10] On the other hand, transfers occurring more than two years apart ''are presumed not to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.''[11]

If the transfers fall within the two-year presumption, and the partner treats the transfers as other than a sale for tax purposes, then the partner must file a disclosure statement with the partner's return for the taxable year of the transfer on either a completed IRS Form 8275 or on a separate statement including a caption identifying the statement as disclosure under §707 and providing the ''facts affecting the potential tax treatment of the item (or items) under §707.[12]

According to the proposed regulations to the disguised sale regulations, Treasury and the IRS determined that based upon the statute and legislative history, transfers to and from a partnership should be treated as related and characterized as components of a disguised sale only to the extent ''that their combined effect is to allow the transferring partner to withdraw all or part of his or her equity in the transferred property.'' The preamble to the proposed regulations provides:

> Under this equity-withdrawal approach, a contribution of property to the partnership will not be treated as part of a disguised sale if the transferring partner is merely converting his or her equity in the transferred property into an interest in partnership capital that is subject to the entrepreneurial risks of partnership operations. Thus, if a partner contributes property to a partnership and, as a result, the partner's equity in the contributed property is converted into a genuine entrepreneurial interest in partnership capital, any subsequent distributions that liquidate that capital interest should not be treated as related to the contribution. If, on the other hand, a partner's equity in the contributed property is not converted, in substance as well as form, into a genuine interest in partnership capital that is subject to the entrepreneurial risks of partnership operations, any distributions that represent a withdrawal of the partner's equity in the transferred property are properly characterized as part of a disguised sale of the property under section 707(a)(2).[13]

Tracking Allocations Can Create a Disguised Sale Risk

Example 8 of the disguised sale regulations, which pre-dates promulgation of regulations under the partnership anti-mixing bowl rules, discussed below, underscores the potential application of the disguised sale rules in §707(a)(2)(B) and Reg. §1.707-3 to mixing bowl partnerships, at least in fairly egregious factual circumstances. In the example, Partner I contributes an unencumbered office building having a value of $50,000,000 and an adjusted tax basis of $20,000,000 to IJK partnership. Partners J and K each contribute U.S. government securities having a value and adjusted tax basis of $25,000,000 to the partnership. Substantially all of the rentable space in the office building is leased on a long-term basis, and it is not expected that the partnership will need to resort to the government securities or cash flow from the securities to operate the office building. At the time the partnership is formed, the partners ''contemplated'' that Partner I's interest would be liquidated sometime after three years. The partnership allocates 90% of all items of income, gain, loss and deduction with respect to the office building to Partners J and K (45% to each) and 10% to Partner I. Likewise, the partnership allocates 90% of all items of income, gain, loss and deduction with respect to the government securities to Partner I and 10% (5% to each) to Partners J and K. Three years and one month after formation, the part-

[8] Reg. §1.707-3(b)(2).

[9] See, for example, the Tax Court's recent decision in *Gateway Hotel Partners, LLC v. Commissioner*, T.C. Memo 2014-5, where the Tax Court analyzed each factor on the list in reaching its conclusion that the transfer of historic state tax credits to a partner contributing cash to the partnership was not a disguised sale of property by the partnership to the partner.

[10] Reg. §1.707-3(c)(1).

[11] Reg. §1.707-3(d).

[12] Reg. §1.707-3(d), §1.707-8(b). IRS Form 8275 is the disclosure statement required to avoid substantial understatement and negligence penalties under §6662. An exception to disclosure applies if the transfer of cash or other consideration by the partnership to the partner is presumed to be a reasonable guaranteed payment, reasonable preferred return, or distribution of operating cash flow as determined under Reg. §1.707-4.

[13] Notice of Proposed Rulemaking, PS-163-84, 56 Fed. Reg. 19,055 (Apr. 25, 1991).

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nership transfers the government securities and cash representing the excess of partner I's share of appreciation in the office building over Partners J and K's share of the appreciation in the government securities since the time of formation of IJK partnership.

The example concludes that the transfers to and from the partnership are treated as part of a sale. According to the example, the amount and timing of the subsequent transfer of government securities to Partner I was ''anticipated'' and did not depend on the entrepreneurial risks of partnership operations. Moreover, the example notes, the allocations were ''designed to effect an exchange of the burdens and benefits of the government securities in anticipation of the transfer of those securities'' to Partner I.

The example has puzzled tax practitioners since the issuance of the proposed disguised sale regulations that initially included it, particularly as to whether the same conclusion would have been reached if any of the various factors was not present. The preamble to the final regulations noted with respect to this example that the IRS and Treasury had received ''numerous comments requesting more specific guidance.'' In response, the IRS and Treasury retained the example in the final regulations but noted, ''the example relies on a confluence of factors and is not intended to provide bright-line guidance or to indicate whether the result might change if one or more of the enumerated factors were changed or eliminated.''[14]

The example does not easily carry over to a real estate mixing bowl partnership formed by consolidating various property-owning partnerships where the amount of distributions in liquidation of each member's capital is subject to all of the entrepreneurial risks of real estate ownership. For example, upon its formation, say, the mixing bowl partnership owns 20 properties the aggregate value of which are $500x, and Partner A has a 20% interest in the partnership. The partners contemplate upon formation of the mixing bowl partnership to liquidate the company after three years, at which time Partner A would receive properties representing 20% of the value of the company. Say, after three years, the value of some of the properties has gone up, and the value of others has gone down, and the aggregate value of all of the company's properties is $600. At this point, the members of the company would still need to determine which members get which properties. Moreover, the values of each partner's capital will rise and fall depending upon the performance of partnership operations generally It would seem that the IRS would be hard pressed to argue, for instance, that any of the members did not subject their capital to the entrepreneurial risks of the operations of this mixing bowl partnership.

Alternatively, a factor suggesting disguised sale treatment might be if Partner A had a contractual right to receive a predetermined property in liquidation of his interest regardless of its value relative to other partnership properties. The more difficult case would be if Partner A was allocated 90% of the profits, losses and distributions with respect to a particular property held by the partnership and, after the three-year period, received that property in liquidation of his interest. The allocations coupled with the right to receive that specific property would suggest that the transfer of that property to Partner A was a foregone conclusion and thus part of a sale. However, that partner did bear some entrepreneurial risk of partnership operations.

Risk of Disguised Sale Treatment Is Minimized as Property Is Subject to Entrepreneurial Risk of Partnership Operations

In the context of a mixing bowl transaction where partners may contribute various properties in which they hold interests, but have an expressed or implied objective to receive certain of those properties at some point, perhaps predetermined, after the formation of the partnership, the difficult question arises as to whether those expectations give rise to a disguised sale inference. It would not be uncommon for the contributing partners to have their eye on certain properties going in, and it would not be atypical for them to have expressed those preferences at the inception. Despite the advice of counsel, the partners may have negotiated the outcome of who will get which properties. This fact pattern can be challenging for the tax practitioner in determining whether there is a disguised sale. Nevertheless, if the mixing bowl partnership does have a sufficient duration so that the success of the individual properties may have time to vary, the original expectations of the partners may, in fact, change. If, for example, a partner had expressed a desire to receive a certain property at the inception of the mixing bowl partnership, but that property failed to perform, no doubt that partner would revisit his selection. The properties would be, during the term of the partnership, subject to the entrepreneurial risks of partnership operations. As long as the preferences are not reduced to a binding contractual right, there should not be a disguised sale. However, there may be a challenging paper trail should the transaction undergo scrutiny by the taxing authorities.

Assuming the partners do not preselect the properties going into the mixing bowl partnership, the question arises as to how long do they have to remain in

[14] T.D. 8439, 57 Fed. Reg. 44,974 (Sept. 30, 1992).

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the mixing bowl experience for the later transfers of property to be dependent on the entrepreneurial risks of partnership operations. Thus, if the mixing bowl partnership held properties that were not completely stabilized (e.g., not subject to long-term leases), could the mixing bowl partnership unwind before the expiration of the two-year disguised sale presumption? Could the partners engage in a bidding process during the first two years of the mixing bowl partnership? If the division occurs within the two-year period subsequent to the merger into the mixing bowl partnership, the transaction would be ''presumed'' to be a disguised sale. Depending upon the facts and circumstances, the parties may be able to demonstrate facts to overcome that presumption. However, that would be a difficult burden. The transaction would be subject to reporting requirements which could draw greater scrutiny. Although it may be theoretically possible to overcome the disguised sale presumption, it would be advisable for the parties to wait until after the two-year period unless there are compelling non-tax reasons to end the arrangement sooner.

NAVIGATING THE PARTNERSHIP IN ANTI-MIXING BOWL PROVISIONS §704(c)(1)(B) AND §737 AND THEIR EXCEPTIONS

As if subchapter K is not complicated enough by the limitations on tax-free treatment under §721 and §731 and the disguised sale provisions in §707(a)(2)(B), Congress deemed it necessary to add the anti-mixing bowl provisions of §704(c)(1)(B) and §737. One of the greatest attributes of subchapter K is the ability to move property in and out of a business entity without triggering gain recognition. However, this characteristic has been subject to abuse. While the disguised sale rules were designed to prevent a partnership from being used to effect what is in substance a sale either between the partners or between the partners and the partnership, the anti-mixing bowl rules appear to have been designed to prevent partners from effectuating a non-taxable basis swap through transfers of property to and from a partnership and to avoid taxation on pre-contribution gain under §704(c)(1)(A). For instance, if two partners could form a partnership where Partner A contributes Blackacre with a basis of $0 and value of $100, and Partner B contributes Whiteacre with a basis of $40 and value of $100, and through a series of transfers to and from the partnership Partner A became the owner of Whiteacre with a $0 basis, and Partner B became the owner of Blackacre with a $40 basis, the partners have achieved a result that presumably Congress did not intend. To block such perceived abuses, §704(c)(1)(B) can trigger gain recognition if property contributed by a partner and having pre-contribution gain is distributed to another partner within seven years of the original contribution. Section 737 can trigger gain recognition if a partner having contributed property with pre-contribution gain receives a distribution of other property from the partnership within seven years of the original contribution.

Section 704(c)(1)(B) Protects Against Basis Shifting by Taxing Pre-Contribution Gain Upon Distribution Of Contributed Property

This article follows the rationale of the 2007 proposed regulations under §704(c)(1)(B) and §737 that any built-in gain resulting from the contribution of properties to the mixing bowl partnership by the terminating partnerships is subject to the anti-mixing bowl provisions.[15] Under the 2007 proposed regulations the partners of a terminated partnership in an assets-over merger are deemed to contribute an undivided interest in the property owned by each terminated partnership to the continuing partnership, with the contribution resulting in new built-in gain subject to §704(c)(1)(B) and §737 for any property having a fair market value in excess of basis (for book purposes) at the time of contribution.[16]

As an important exception, the merger of partnerships into the mixing bowl partnership will not result in the creation of new §704(c) gain or loss subject to the anti-mixing bowl rules if all of the partnerships being merged have identical ownership or if the difference in ownership is de minimis. Under the 2007 proposed regulations, the difference in ownership is de minimis ''if ninety seven percent of the interests in book capital and in each item of income, gain, loss, deduction and credit and shares of distributions and liabilities of the transferor partnership and transferee partnership are owned by the same owners in the same proportions.''[17]

To fully comprehend the anti-mixing bowl provisions it is necessary to have a basic understanding of §704(c)(1)(A). Section 704(c)(1)(A) provides:

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[15] The authors acknowledge that the regulations have still not been finalized after seven years and that some tax practitioners have taken the position that the IRS's approach under the 2007 proposed regulations is inconsistent with the current regulations. *See* Notice 2005-15, 2005-7 I.R.B. 527.

[16] Prop. Reg. §1.704-4(c)(4)(ii)(B).

[17] Prop. Reg. §1.704-4(c)(4)(ii)(E), §1.737-2(b)(1)(ii)(E); Notice 2005-15, 2005-7 I.R.B. 527. An exception to the anti-mixing bowls based on identical ownership interests in the merged entities was first announced in Notice 2005-15 preceding the proposed regulations. The IRS has applied the identical ownership exception in at least one private ruling. *See* PLR 200631014 (merger of two limited partnerships having identical ownership did not result in new §704(c) property for purposes of §704(c)(1)(B) and §737 pursuant to the ''identical ownership ex-

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(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

The provision is designed to prevent a partner who contributes appreciated property to a partnership to avoid the tax incidents of that appreciation.

Section 704(c)(1)(B), in turn, acts as a buttress to §704(c)(1)(A). That section provides, "under regulations prescribed by the Secretary":

(B) if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed —

(i) the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under subparagraph (A) by reason of the variation described in subparagraph (A) if the property had been sold at its fair market value at the time of the distribution,

(ii) the character of such gain or loss shall be determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the partnership to the distributee, and

(iii) appropriate adjustments shall be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under this subparagraph.

Mechanically, under §704(c)(1)(B), if property contributed to the partnership having pre-contribution gain is distributed to another partner within seven years of contribution, the contributing partner must recognize gain at the time of distribution based upon the fair market value of the property at the time of distribution. The fair market value of the distributed property is determined generally under a "willing buyer, willing seller" standard, although "the fair market value that a partnership assigns to distributed §704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests."[18] The character of the gain or loss is determined by reference to the character of the gain or loss that would have resulted if the distributed property had been sold by the partnership to the distributee partner.[19] The contributing partner's adjusted basis in the partnership is increased by the amount of gain recognized under this section. The adjustment is taken into account in determining such partner's basis under §732 for any property distributed to the partner in a distribution that is part of the same distribution as the distribution of the contributed property and for purposes of determining the amount of gain recognized by the contributing partner under §737, if any, on a distribution of property to the contributing partner that is part of the same distribution as the distribution of the contributed property.[20] The partnership increases its basis in the distributed property immediately before the distribution by the amount of gain recognized by the contributing partner, and this adjustment is taken into account in determining the distributee partner's adjusted tax basis in the distributed property under §732.[21]

ception" set forth in Notice 2005-15).

Section 737 Protects Against Basis Shifting by Taxing Pre-Contribution Gain Upon Distribution Of Other Property to the Contributing Partner

Under the second partnership anti-mixing bowl rule, §737, a partner who contributes appreciated property to a partnership may be required to recognize gain upon the distribution of different property from the partnership having a value in excess of the partner's adjusted basis in its partnership interest to the extent of the partner's "net precontribution gain."

Section 737(a) provides:

In the case of any distribution by a partnership to a partner, such partner shall be treated as recognizing gain in an amount equal to the lesser of —

(1) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of such partner's interest in the partnership immediately

[18] Reg. §1.704-4(a)(3).

[19] §704(c)(1)(B)(ii); Reg. §1.704-4(b)(1).

[20] §704(c)(1)(B)(iii); Reg. §1.704-4(e)(1). An important exception is that there would be no adjustment to the partner's basis in its interest in the partnership in the event the special rule for distributions of like-kind property applies. *See* Reg. §1.704-4(e)(1).

[21] §704(c)(1)(B)(iii); Reg. §1.704-4(e)(2).

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> before the distribution reduced (but not below zero) by the amount of money received in the distribution, or
>
> (2) the net precontribution gain of the partner.
>
> Gain recognized under the preceding sentence shall be in addition to any gain recognized under section 731. The character of such gain shall be determined by reference to the proportionate character of the net precontribution gain.

Section 737(b) provides:

> For purposes of this section, the term ''net precontribution gain'' means the net gain (if any) which would have been recognized by the distributee partner under §704(c)(1)(B) if all property which —
>
> (1) had been contributed to the partnership by the distributee partner within 7 years of the distribution, and
>
> (2) is held by such partnership immediately before the distribution,
>
> had been distributed by such partnership to another partner.

Mechanically, under §737 and regulations thereunder, a partner that receives a distribution of property (other than money) must recognize gain equal to the lesser of the ''excess distribution'' or the partner's ''net precontribution gain.''[22] The excess distribution amount is defined as ''the amount (if any) by which the fair market value of the distributed property (other than money) exceeds the distributee partner's adjusted tax basis in the partner's partnership interest.''[23] The fair market value of the distributed property is determined generally under a ''willing buyer, willing seller'' standard, although ''the fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.''[24] While the regulations add more complexity, the character of gain recognized under §737 is determined by reference to the character of gain or loss in §704(c) property contributed by the distributee partner.[25] The distributee partner's adjusted basis in its interest in the partnership is increased by the amount of gain recognized under §737, effective immediately before the distribution.[26] The partnership's adjusted basis in ''eligible property'' is increased by the amount of gain recognized by the distributee partner under §737, where eligible property includes only those items of property that (i) entered into the calculation of the distributee partner's net precontribution gain, (ii) have a fair market value greater than basis at the time of distribution, (iii) would have the same character on a sale by the partnership as the character of gain recognized by the distributee partner under §737, and (iv) are not distributed to another partner in a distribution subject to §704(c)(1)(B) that was part of the same distribution as the distribution subject to §737.[27]

As a matter of coordination between §704(c)(1)(B) and §737, §704(c)(1)(B) is applied first before §737 if, as part of a related distribution, property other than contributed property is distributed to the contributing partner and contributed property is distributed to another partner. Thus, the increase to the adjusted basis of the contributing partner's interest in the partnership prescribed by §704(c)(1)(B) is taken into account in determining the amount of gain recognized by the contributing partner under §737 on a distribution of property to the contributing partner that is part of the same distribution as the distribution of the contributed property.[28] In addition, the distributee partner's net precontribution gain under §737 is determined after taking into account any gain or loss recognized by the partner under §704(c)(1)(B) as part of the same distribution.[29]

Section 704(c)(2) Permits Basis Shifting on Related Distributions of Like-Kind Property

Statutory Provision and Legislative History

In a provision with the caption, ''Special Rule for Distributions Where Gain or Loss Would Not Be Recognized Outside Partnerships,'' §704(c)(2) provides a meaningful exception to the anti-mixing bowl provisions. In the context of the mixing bowl real estate partnership, the operation of §704(c)(2) may shut off the anti-mixing bowl provisions entirely, which would leave the partners only having to contend with the limitations under §721 and §731 and the disguised sale rules of §707(a)(2)(B) (with its two-year presumption). The upshot is that if §704(c)(2) applies, then the seven-year holding period may be inapplicable. Thus, §704(c)(2) provides:

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[22] Reg. §1.737-1(a)(1).
[23] Reg. §1.737-1(b)(1).
[24] Reg. §1.737-1(b)(2).
[25] §737(a); Reg. §1.737-1(d).
[26] §737(c)(1); Reg. §1.737-3(a).
[27] §737(c)(2); Reg. §1.737-3(c)(1)–§1.737-3(c)(2).
[28] *See* Reg. §1.704-4(e)(1).
[29] Reg. §1.737-1(c)(2)(iv).

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Under regulations prescribed by the Secretary, if

(A) property contributed by a partner (hereinafter referred to as the "contributing partner") is distributed by the partnership to another partner, and

(B) other property of a like kind (within the meaning of §1031) is distributed by the partnership to the contributing partner not later than the earlier of —

(i) the 180th day after the date of the distribution described in subparagraph (A), or

(ii) the 180th day after the date of the due date (determined with regard to extensions) for the contributing partner's return of the tax imposed by this chapter for the taxable year in which the distribution described in subparagraph (A) occurs,

then to the extent of the value of the property described in subparagraph (B), paragraph (1)(B) shall be applied as if the contributing partner had contributed to the partnership the property described in subparagraph (B).[30]

This so-called "Special Rule" will often allow partners in a real estate mixing bowl partnership to completely avoid gain recognition under the anti-mixing bowl provisions in cases where the mixing bowl partnership is liquidated *prior to seven years* and the different partners each receive either a 100% interest in various properties owned by the partnership or a tenancy-in-common interest in such properties.

According to the Committee report to the Revenue Reconciliation Act of 1989, the Special Rule in §704(c)(2) treats the like-kind property distributed to the contributing partner as the contributed property:

In cases where a partner has contributed property to a partnership that is distributed to another partner or partners and other property of a like kind is distributed to the contributing partner by the partnership, the like-kind property received is treated as if it were a return of the contributing partner's own property (generally, a tax-free distribution under Code §731). The determination of what property is of like kind is made under Code §1031 rules. However, for there to be nonrecognition of gain or loss, such like-kind property must be distributed by the partnership to the contributing partner no later than the earlier of (1) the 180th day after the date on which the originally contributed property was distributed to another partner or (2) the due date (determined without [sic] regard to extensions[31]) for the contributing partner's return for the tax year in which the original distribution of property occurred.

Implementation of the Special Rule Under Treasury Regulations

The Special Rule in §704(c)(2) by its terms applies "under regulations prescribed by the Secretary." The regulations provide that the amount of gain or loss that would otherwise be recognized under §704(c)(1)(B) is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner:

If §704(c) property is distributed to a partner other than the contributing partner and like-kind property (within the meaning of §1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the non-contributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the noncontributing partner, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under §704(c)(1)(B) and this section is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase

[30] Note that the statutory language is ambiguous how the 180-day timing limitation applies if, as part of a related distribution, like-kind property is distributed to the contributing partner *prior to* the distribution of the contributed property to another partner. Technically, the like-kind property would have been distributed to the contributing partner "not later than" the 180th day after the distribution of the contributed property even if distributed, say, 181 days prior to the distribution of the contributed property. Arguably, in keeping with the policy of the Special Rule in §704(c)(2), the distributions in such case ought to occur within a 180-day period. In the example in the regulations, described below, the properties are distributed on the same date.

[31] This date is determined with regard to extensions under §704(c)(2) as enacted.

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> in the contributing partner's adjusted tax basis in the partnership interest under §704(c)(1)(B) and this section. See Reg. §1.707-3 for provisions treating the distribution of the like-kind property to the contributing partner as a disguised sale in certain situations.[32]

The example in the regulations illustrates a condition to the application of §704(c)(2) that is not apparent from the statutory language. This condition appears designed to ensure that a partner wishing to avoid any gain recognition under §704(c)(1)(B) must take at least as much built-in gain in the property received in the distribution as was inherent in the contributed property. The regulation illustrates this principle with an example where there is a ''current'' nonliquidating distribution that would, but for this limitation, enable the recipient partner to receive property having less built-in gain than the contributed property.

> *Example. Distribution of like-kind property.* (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $20,000 and an adjusted tax basis of $10,000. B and C each contribute $20,000 cash. The partnership subsequently buys Property X, nondepreciable real property of a like kind to Property A with a fair market value and adjusted tax basis of $8,000. The fair market value of Property X subsequently increases to $10,000.
>
> (ii) On December 31, 1998, Property A is distributed to B in a current distribution. At the same time, Property X is distributed to A in a current distribution. The distribution of Property X does not result in the contribution of Property A being properly characterized as a disguised sale to the partnership under Reg. §1.707-3. A's basis in Property X is $8,000 under §732(a)(1). A therefore has $2,000 of built-in gain in Property X ($10,000 fair market value less $8,000 adjusted tax basis).
>
> (iii) A would generally recognize $10,000 of gain under §704(c)(1)(B) on the distribution of Property A, the difference between the fair market value ($20,000) of the property and its adjusted tax basis ($10,000). This gain is reduced, however, by the amount of the built-in gain of Property X in the hands of A. As a result, A recognizes only $8,000 of gain on the distribution of Property A to B under §704(c)(1)(B) and this section.

In the Notice of Proposed Rulemaking promulgating the proposed regulations, Treasury and the IRS explained the regulation as follows:

> This special rule implements the statutory objective of not requiring gain or loss on distributions where gain or loss would not have been recognized outside of a partnership. When gain or loss is not recognized in exchanges of like-kind property outside of partnerships, the built-in gain or loss on the exchanged property is generally preserved in the property received in the exchange. To the extent that this built-in gain or loss is not preserved in the case of a distribution of the property by the partnership, the exception does not apply.[33]

Subsequently, in the preamble to the final regulations, Treasury and the IRS defended the rule in the proposed regulations against criticism that the rule was inconsistent with the statutory provision. According to the preamble,

> If the contributing partner, however, had engaged in a like-kind exchange outside of the partnership, the partner's built-in gain or loss in the like-kind property received would have been the same as the property that was surrendered. The rule in the proposed regulations reflects this result by limiting the application of section 704(c)(2) to the extent that the built-in gain or loss in the contributed property is not preserved in the like-kind property distributed to the contributing partner. The IRS and Treasury continue to believe that the regulations properly implement Congress' objective with respect to this provision. Therefore, the regulations are finalized without change.[34]

It should be noted that this limitation would not, in general, be applicable to a distribution in liquidation of a mixing bowl partnership (assuming inside and outside basis are not disparate) since basis of the distributed property in a liquidating distribution takes on the basis of the partner in its partnership interest pur-

[32] Reg. §1.704-4(d)(3).

[33] Notice of Proposed Rulemaking, PS-76-92, PS-51-93, 60 Fed. Reg. 2353 (Jan. 9, 1995).

[34] T.D. 8642, 60 Fed. Reg. 66,727 (Dec. 26, 1995).

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suant to §732(b). Contrast a nonliquidating or ''current'' distribution where, in general, there is a carryover basis regime under §732(a).[35]

No Gain Recognition Under §737 If Contributed Property Is Distributed in Related Distribution And §704(c)(2) Applies

Although not immediately evident from the statute, the regulations under §737 are coordinated with the Special Rule in §704(c)(2) to allow a partner to avoid gain recognition under §737 if contributed property is distributed to another partner as part of the same distribution as the distribution of property to the distributee partner and the properties are like-kind.

Reg. §1.737-1(c)(2)(iv) provides:

> A distributee partner's net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and §1.704-4 (*or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and §1.704-4(d)(3)*) on an actual distribution to another partner of §704(c) property contributed by the distributee partner that is part of the same distribution as the distribution to the distributee partner.[36]

As noted above, the provisions of §704(c)(1)(B) are applied first before the provisions of §737. Thus, a partner's net precontribution gain will be reduced by gain recognized under §704(c)(1)(B) upon the distribution of contributed property to another partner.[37] By virtue of the emphasized language in Reg. §1.737-1(c)(2)(iv), cited above, a partner's net precontribution gain for §737 will also be reduced by any gain that would have been recognized by the partner under §704(c)(1)(B) but for §704(c)(2).

Treasury and the IRS appear to have believed that the use of the conditional tense in referring to the gain that ''would have been recognized except for the like-kind exception'' in Reg. §1.737-1(c)(2)(iv), cited above, may be ambiguous as to whether an actual distribution of the property contributed by the distributee partner is necessary for the rule to apply. Thus, Reg. §1.737-1(c)(2)(v), with its caption ''Section 704(c)(2) disregarded,'' reinforces that an actual distribution of contributed property to another partner is necessary for the rule in Reg. §1.737-1(c)(2)(iv) to take effect:

> A distributee partner's net precontribution gain is determined without regard to the provisions of section 704(c)(2) and section 1.704-4(d)(3) in situations in which the property contributed by the distributee partner is *not actually distributed* to another partner in a distribution related to the §737 distribution.[38]

In the preamble to the final Treasury regulations, Treasury and the IRS rejected a commentator's suggestion to delete the provision as ''superfluous.'' The preamble notes, ''This provision clarifies that §737 does not contain a like-kind exception similar to the exception in §704(c)(2). Section 737 applies even if the property received by the partner is of a like-kind with the contributed property.''[39]

The upshot of this back-and-forth is that gain under §737 can often be avoided if the contributed property is distributed to other partners as part of the same distribution of other property to the distributee partner. If contributed property is not actually distributed to other partners as part of the same distribution, then the mere fact that property received by the distributee partner is like-kind to the contributed property will not help avoid gain recognition under §737.

CONCLUSION: THE TWO-YEAR MIXING BOWL

The anti-mixing bowl provisions may not have as broad an application as they may appear to have at first blush. In a properly planned and executed mixing bowl partnership designed to effectuate the division of a real estate portfolio formerly held in brother/sister partnerships, the anti-mixing bowl provisions of §704(c)(1)(B) and §737 should not be a barrier to a liquidation of the mixing bowl partnership in less than seven years after its creation. The exception to these rules in §704(c)(2) for like-kind distributions should provide a workable solution in most instances, as long as the distributed properties consist of interests in real estate (including tenancies in common) as opposed to partnership interests. While the regulations under §704(c)(2) limit the application of the special rule in situations where a partner receives a distribution of property that has less built in gain than that partner's

[35] In cases where there is a disparity between a partner's outside basis and share of inside basis, e.g., resulting from the transfer of an interest in the partnership or death of a partner where the partnership has made no §754 election, it is conceivable that the requirements for full nonrecognition under §704(c)(2) will be achieved only through a current distribution of property rather than in liquidation of the partner's interest in the partnership. Each situation must be closely scrutinized to determine the applicability of these provisions and ways to achieve the optimal tax result.

[36] Reg. §1.737-1(c)(2)(iv) (emphasis added).

[37] Reg. §1.704-4(e)(1).

[38] Reg. §1.737-1(c)(2)(v) (emphasis added).

[39] T.D. 8642, 60 Fed. Reg. 66,727 (Dec. 26, 1995).

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precontribution gain, as a practical matter, the rules regarding basis in distributed property under §732 should generally preserve the entire precontribution gain in the distributed property where a partner's interest is liquidated (including a liquidation of the entire partnership). In the case of complete liquidation of the partnership or of a partner's interest in the partnership there is virtually no opportunity to avoid carrying out the pre-contribution gain to the contributing partner, which will be embodied in the property received in the liquidating distribution.

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