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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR KANSAS-MISSOURI ASSOCIATE DISTRICT COUNSEL

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Disposition of Partnership Interest

This Field Service Advice responds to your memorandum dated November 5, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

P =
Q =

R =
S =
T =
U =
$r = $
$s = $
$t = $
u =
v =
w =
x =
y =
z =
Year 1 =
Year 4 =
Year 5 =

ISSUE:

Whether Q's interest in P was liquidated by P or purchased by U.

CONCLUSION:

Q's interest in P was purchased by U.

FACTS:

Q is a wholly owned corporation of T, a domestic corporation. R is a wholly owned domestic corporation of S, a foreign corporation. U is a foreign corporation owned u percent by S.

In Year 1, Q, R, and U formed P, a domestic partnership. In exchange for a v percent partnership interest, Q contributed its U.S.-based assets. In exchange for a w percent partnership interest, R contributed its assets related to the production of tools (both U.S. and foreign based). In exchange for an x percent partnership interest, U contributed $r.

On August 31, Year 4, P, Q, R, S, T and U executed a Redemption Agreement. Pursuant to the Redemption Agreement, on the redemption date, Q's entire interest in P would be redeemed for $s and contingent payments based on future sales for the next y years, but not aggregating in excess of $t. The redemption date was September 30, Year 5. In the recitals, the Redemption Agreement provided that P and Q desired that, upon the terms and subject to the conditions set forth in the agreement, P redeem the entire interest of Q in P. The agreement contained a provision through which, if a specified notice were provided, the transaction could be structured as a sale. Finally, the agreement provided that the parties agreed to treat, for income tax purposes, the redemption distributions as distributions by P under section 731 when such payments were made to Q.

On September 20, Year 5, R and U entered into a Contribution Agreement. Pursuant to the Contribution Agreement, prior to the redemption date, U would contribute $s to P for the purpose of funding the payment to be made to Q. No later than the due date of each contingent payment required to be made under the Redemption Agreement, U was required to make a contribution to P in an amount equal to the amount of the contingent payment. After U's contribution of $s to P, U had a z percent partnership interest in P and R's interest remained w percent.

On September 30, Year 5, R and U entered into an Amended and Restated Joint Venture Agreement of P.

LAW AND ANALYSIS

Where money is distributed by a partnership to a partner in liquidation of his interest, no gain is recognized to the partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. I.R.C. § 731(a)(1); Treas. Reg. § 1.731-1(a)(1)(i). In general, the distributee partner does not recognize a loss. I.R.C. § 731(a)(2). However, where no property other than money, unrealized receivables and inventory are distributed to such partner, the partner will recognize a loss to the extent the excess of the adjusted basis of the partner's interest in the partnership exceeds the sum of the money distributed and the basis of any unrealized receivables and inventory. I.R.C. § 731(a)(2); Treas. Reg. § 1.731-1(a)(2). The gain or loss realized will be capital gain or loss. I.R.C. § 731(a); Treas. Reg. § 1.731-1(a)(3).

Such treatment, however, applies only to payments made by the partnership to a partner and not to transactions between partners. If there is a transfer of money by a partner to a partnership, there is a related direct or indirect transfer of money by the partnership to another partner, and the transfers, when viewed together are properly characterized as a sale or exchange of property, the transfers shall be treated either as a transaction occurring between the partnership and one who is not a partner or as a transaction between two or more partners acting other than in their capacity as members of the partnership. I.R.C. §§ 707(a)(1), (a)(2)(B); Treas. Reg. § 1.731-1(c)(3).

In the case of a sale or exchange of an interest in a partnership, except to the extent section 751(a) applies, the transferee partner recognizes capital gain or loss. I.R.C. §§ 1001(c), 741; Treas. Reg. § 1.741-1(a). The amount of the gain or loss is the difference between the amount realized and the adjusted basis of the partnership interest as determined under section 705. Treas. Reg. § 1.741-1(a). This treatment applies regardless of whether the interest is sold to other members of the partnership or to persons who are not members of the partnership. Treas. Reg. § 1.741-1(b).

Subchapter K was adopted in part to increase flexibility among partners in allocating partnership tax burdens. I.R.C. § 701-776; Foxman v. Commissioner, 41 T.C. 535, 550-51 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965). This flexibility, however, is limited by the overarching principle that the substance of the transaction is controlling for tax purposes. Twenty Mile Joint Venture, PND, Ltd. v. Commissioner, 2000-1 U.S.T.C. (CCH) ¶ P50,124 (10th Cir. 1999), aff'g in part and appeal dismissed in part, T.C. Memo. 1996-283; Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793, 813-14 (1988). The economic substance of the transaction, and not the form, determines its characterization. Treas. Reg. § 1.707-

1(a); Jacobson v. Commissioner, 96 T.C. 577, 587-88 (1991), aff'd, 963 F.2d 218 (8th Cir. 1992) citing S. PRINT NO. 98-169, Vol. I, at 225 (1984); H. R. REP. NO. 98-432, at 1218 (1984).

> To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

The form of the transaction was a liquidation. In the recitals, the Redemption Agreement provided that P and Q desired that, upon the terms and subject to the conditions set forth in the agreement, P redeem the entire interest of Q in P. The agreement contained a provision through which, if a specified notice were provided, the transaction could be structured as a sale. (There is no indication that any such notice was ever provided.) Finally, the agreement provided that the parties agreed to treat, for income tax purposes, the redemption distributions as distributions by P under section 731 when such payments were made to Q.

The court, however, will look behind the chosen form of a transaction where "elements of artificiality" are present. The presence of such elements can be ascertained by looking at the business purpose for the transaction. Jacobson, 96 T.C. at 590. One element of artificiality is that the funds used to terminate Q's interest were derived from U, and not from P. Jacobson, 96 T.C. at 592. Pursuant to the Redemption Agreement, Q's entire interest in P would be redeemed for $s and certain contingent payments. Ten days before the redemption date, R and U entered into an agreement wherein U would contribute $s to fund the payment to be made to Q. The agreement also provided that U was required to make a contribution to P in an amount equal to each of the contingent payments to be made to Q.

Another element of artificiality is that the continuing partners' interest did not increase proportionately upon the withdrawal of the partner. Specifically, to the extent the interests of the continuing partners' interest does not increase proportionately upon the withdrawal of a partner, the economic substance of the transaction is generally considered a sale. Colonnade Condominium, Inc., supra (where new general partners were admitted to a limited partnership, the interests of one pre-admission general partner decreased, and the interests of all pre-admission limited partners remain unchanged, holding that the general partner whose interest decreased sold a portion of its partnership interest to the new general partners); Coven v. Commissioner, 66 T.C. 295 (1976) (holding that the termination of a partner's interest was a sale of the interest to a partner rather than a liquidation because, among other things, the majority partner contributed the cash for the terminating payments and its interest increased while the minority partner's interests did not). After U's contribution of $s to P, the continuing partners' (R and U's) interest did not increase proportionateley upon the withdrawal of Q. Rather, U's interest increased to z percent and R's interest remained w percent.

Based on the above facts and circumstances, we conclude that a reasonable inference can be drawn that the overarching business purpose for the transaction was to sell Q's partnership interest in P to U. The substance of the transaction was a transfer of money by a partner, Q, to a partnership, P, followed by a related direct transfer of money by the partnership, P, to another partner, U. The transfers, when viewed together, are properly characterized as a sale or exchange of Q's partnership interest. Accordingly, the transfers must be treated as a transaction between two or more partners acting other than in their capacity as members of the partnership, specifically, as a sale. See I.R.C. § 707(a)(2)(B).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call if you have any further questions.

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