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ISSUE

Does a corporation that acquires assets of another corporation in a transaction described in § 381(a) of the Internal Revenue Code succeed to the status of the other corporation for purposes of applying the exception for reimbursements of preformation expenditures and determining whether a liability is a qualified liability under the regulations regarding the disguised sale provisions of § 707(a)(2)(B)?

FACTS

Corporation *P* owns all of the stock of corporation *S*. *S* has only one asset, rental property, that is encumbered by a nonrecourse liability of $40*x* originally incurred by *S* on January 1, 1995. *S* incurred $5*x* in capital expenditures with respect to the rental property on December 1, 1998.

On January 1, 1999, *S* distributes the rental property, subject to the $40*x* liability, to *P* in a transaction that qualifies as a complete liquidation of *S* within the meaning of § 332.

On January 1, 2000, *P* contributes the rental property, subject to the $40*x* liability, to a partnership (*PRS*) in exchange for an interest in *PRS*. In connection with the transaction, *PRS* reimburses *P* $5*x* for the capital expenditures incurred by *S* with respect to the contributed property. At the time that *P* transfers the rental property to *PRS*, the rental property has a fair market value of $100*x* and an adjusted basis of $70*x*.

LAW

Section 721(a) provides that 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 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.

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of the individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

Section 707(a)(2)(B) provides that 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 the partner (or another partner), and (iii) the transfers when viewed together are properly characterized as a sale or exchange of property, then the transfers shall be treated either as a transaction between the partnership and a partner not acting in the partner's capacity as a partner or as a transaction between two or more partners acting other than in their capacity as partners.

Section 1.707–3(a) of the Income Tax Regulations provides that, except as otherwise provided in § 1.707–3, 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 the partner constitute a sale based on all the facts and circumstances, the transfers are treated as a sale of property to the partnership.

Section 1.707–3(c)(1) provides that if within a 2-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.

Section 1.707-4(d) provides that, in general, notwithstanding the presumption relating to transfers made within 2 years of each other, a transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under § 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 2-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 § 709; or (ii) property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of the property at the time of the contribution (preformation expenditures).

Section 1.707-5(a)(1) provides that for purposes of the disguised sale rules, if a partnership assumes or takes property subject to a qualified liability, as defined in

§ 1.707-5(a)(6), the partnership is treated as transferring consideration to the partner only to the extent that the transfer of property to the partnership is otherwise treated as part of a sale. By contrast, if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability as provided in § 1.707-5(a)(2), (3), and (4).

Under § 1.707-5(a)(6), a qualified liability is (1) a liability that was incurred by the partner more than 2 years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that 2-year period; (2) a liability that was incurred within the 2-year period that has encumbered the transferred property since it was incurred, so long as the liability was not incurred in anticipation of the transfer of the property to a partnership; (3) a liability that is allocable under the rules of § 1.163–8T of the temporary Income Tax Regulations to capital expenditures with respect to the property; or (4) a liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business. Certain additional limitations apply with respect to recourse liabilities. See § 1.707–5(a)(6)(ii).

Under § 1.707–4(e), the Commissioner may provide by guidance published in the Internal Revenue Bulletin situations in addition to those specifically addressed in the regulations where payments or transfers to a partner will not be treated as part of a disguised sale.

Section 381(a) references certain transactions that involve one corporation acquiring assets of another corporation in a tax-free transfer (that is, liquidations under § 332, reorganizations under § 368(a)(1)(A), (C), and (F), and certain nondivisive reorganizations under § 368(a)(1)(D) and (G)).

ANALYSIS

The rules regarding preformation expenses and qualified liabilities contained in the disguised sale regulations recognize that certain expenditures will be made, and certain liabilities will be incurred, under circumstances that do not violate the disguised sale rules. Where a corporation incurs preformation expenses or undertakes a borrowing, and another corporation acquires assets of the corporation in a § 381 transaction, the transfer does not alter the circumstances under which the expenditures or indebtedness were originally incurred or otherwise raise concerns that would justify not treating the transferee corporation as having incurred the expenditures or undertaken the liabilities at the time they were incurred or undertaken by the predecessor corporation.

Transactions enumerated in § 381(a) involve situations where the transferor corporation is absorbed by the transferee corporation in a tax-free transaction. Given the purposes for the rules relating to preformation expenses and qualified liabilities, it is appropriate that, in transactions described in § 381(a), the transferee corporation will succeed to the status of the distributor or transferor corporation for purposes of applying the exception for reimbursements of preformation expenditures and determining whether a liability is a qualified liability.

Accordingly, under the facts presented, *P* will succeed to the status of *S* for purposes of determining whether the \$5*x* cash reimbursement from *PRS* qualifies for the exception for reimbursements of preformation expenditures under § 1.707–4(d). *S* incurred \$5*x* in capital expenditures with respect to the rental property on December 1, 1998, which is within the 2-year period preceding the transfer of the property to *PRS*. The reimbursed capital expenditures do not exceed 20 percent of the fair market value of the contributed property. Thus, the \$5*x* cash reimbursement from *PRS* to *P* for the capital expenditures incurred by *S* with respect to the rental property falls within the exception for reimbursement of preformation expenditures and will not give rise to a disguised sale between *P* and *PRS* under § 707(a)(2)(B) and the regulations.

P also will succeed to the status of *S* for purposes of determining whether the \$40*x* liability is a qualified liability within the meaning of § 1.707–5(a)(6). The \$40*x* liability encumbering the property was incurred by *S* on January 1, 1995, which is more than 2 years prior to the date the rental property was contributed to *PRS*. Accordingly, the \$40*x* liability is a qualified liability within the meaning of § 1.707-5(a)(6). As a result, the fact that *P* transfers the rental property to *PRS* subject to the liability will not give rise to a disguised sale between *P* and *PRS* under § 707(a)(2)(B) and the regulations.

HOLDING

A corporation that acquires assets of another corporation in a transaction described in § 381(a) will succeed to status of the other corporation for purposes of applying the exception for reimbursements of preformation expenditures and determining whether a liability is a qualified liability under the regulations regarding the disguised sale provisions of § 707(a)(2)(B).

DRAFTING INFORMATION

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