THE NEED FOR A QUALIFIED DEBT EXCEPTION UNDER PROPOSED REGULATIONS DEALING WITH DISGUISED SALES

By Annie H. Jeong

Annie H. Jeong is an associate with Wachtell, Lipton, Rosen & Katz. She is grateful to Peter C. Canellos, David M. Einhorn, and Joshua D. Blank for their helpful comments and suggestions. The views expressed herein are solely the author's and should not be attributed to her firm or its clients.

In this article, the author provides a brief overview of the current partnership regulations on disguised sales of property, particularly regarding the qualified liability exception, discusses the proposed regulations on disguised sales of partnership interests, and recommends that a qualified liability exception be included in the final regulations on disguised sales of partnership interests. Without such an exception, the author believes that the proposed regulations may be overreaching and produce unintended results.

Copyright 2005 Annie H. Jeong. All rights reserved.

Table of Contents

Introduction ........................................... 1555
Contributions and Distributions Generally ................................ ........ 1555
Current Disguised Sale Regulations ........ 1556
Proposed Regulations ....................... 1558
Criticism of Proposed Regulations ........ 1559
Conclusion ........................................... 1560

Introduction

On November 26, 2004, the Treasury Department issued proposed regulations under section 707 of providing rules for determining when a contribution of property to a partnership and a transfer of money or other consideration from a partnership to a partner should be treated as a disguised sale of a partnership interest. While the proposed regulations adopt many of the principles of the current regulations, they do not include a “qualified liability” carveout to disguised sale treatment. Rather, the preamble to the proposed regulations suggests that the IRS and Treasury do not believe that such an exception is necessary in light of the mechanics of the proposed regulations. Nevertheless, the IRS and Treasury have requested comments on whether rules for qualified liabilities similar to those under current regulations should be included in the proposed regulations and whether and how those rules should be modified to deal with particular issues regarding disguised sales of partnership interests. To carry out the congressional intent of section 707(a)(2)(B) (under which Treasury has authority to issue rules regarding disguised sales), the general exception for qualified liabilities applicable under current regulations to disguised sales of property by a partner to a partnership should apply equally to disguised sales of partnership interests.

Contributions and Distributions Generally

Generally, contributions of property to a partnership in exchange for a partnership interest in the partnership are tax-free under section 721. As a result, neither the partnership nor the contributing partner recognizes gain or loss on the contribution, and appreciated assets can be contributed to a partnership without gain recognition by either the contributing partner on the contribution or the partnership on the issuance of the partnership interest. Similarly, section 731 provides that distributions from a partnership to a partner are tax-free to the distributee partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner’s partnership interest. Thus, the partnership vehicle provides a means by which partners can contribute property and receive distributions of money from a partnership without recognizing gain or loss.

The general rules providing for tax-free contributions to and distributions from a partnership drew the attention of Congress, because they created the opportunity for abusive behavior, in that taxpayers could effect a sale of property while obtaining the benefits of a tax-free transaction. For example, assume that three individuals — A, B, and C — contribute property to AB partnership, in which A, B, and C share equally in profits and losses. A contributes property, in which he has an adjusted tax basis of $50, with a fair market value of $100; B contributes property, in which he has an adjusted tax basis of $50, with a fair market value of $250 and subject to a $150 nonrecourse liability; and C contributes $100 in cash. If $50 of nonrecourse liabilities were allocated to A under
Treas. reg. section 1.752-3(a)(3), A’s basis in his partnership interest would be increased from $50 to $100 ($50 transferred basis plus $50 of nonrecourse debt allocation). Thus, immediately after his contribution, A could receive a distribution equal to $100 in cash from the partnership without recognizing current gain and, in substance, effect a sale, absent any antibuse or other rules to prevent that result.

Thus, in 1984, Congress enacted section 707(a)(2)(B) to deal in particular with those so-called “disguised sales.” Section 707(a)(2)(B) grants Treasury authority to issue regulations prescribing when a transfer of money or other property (directly or indirectly) to a partnership by a partner and a related transfer of money or other property (directly or indirectly) to the partner or another partner by the partnership should be treated as a sale or exchange rather than as a tax-free contribution to and distribution from the partnership.2

Before enactment of section 707(a)(2)(B), the IRS relied primarily on a form of the economic substance doctrine contained in Treas. reg. section 1.731-1(c), which provides that a transaction may not be subject to section 731 if a contribution of property to a partnership occurs and, within a short period of time, either (1) other property is distributed (either before or after the contribution) by the partnership to the contributing partner and the partnership retains the contributed property, or (2) the contributed property is then distributed to another partner. Also, if the distribution were made to effect an exchange of property either between partners or between the partnership and a partner, the transaction would be treated as an exchange of property. Congress, however, enacted section 707(a)(2)(B), expressing concern that Treas. reg. section 1.731-1(c)(3) did “not always prevent de facto sales of property to a partnership or another partner from being structured as a contribution to the partnership, followed (or preceded) by a tax-free distribution from the partnership.”3 While Treas. reg. section 1.731-1(c)(3) provided a means by which the IRS could challenge disguised sales of property, Congress noted that court decisions had chipped away at the doctrine by allowing tax-free treatment in cases that were economically equivalent to a sale of property to either a partnership or another partner.4

In enacting section 707(a)(2)(B), Congress cautioned Treasury against overreaching regulations that could effect the general rules of nonrecognition treatment under sections 721, 731, and 752. The legislative history states, in part:

The Act authorizes the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of [Section 707(a)(2)(B)]. In prescribing these regulations, Congress wanted Treasury to be mindful of its concern with transactions that attempt to disguise a sale of property and not with non-abusive transactions that accurately reflect the economic contributions of the partners. Similarly, Congress did not intend to change the general rules concerning the tax treatment of the partners under sections 721, 731 and 752 to the extent that (1) contributed property is encumbered by liabilities not in anticipation of the contribution, [footnote omitted] or (2) contributions to a partnership which, because of liabilities of the partnership incurred other than in anticipation of the contribution, result in a deemed distribution under section 752(b).5 (Emphasis added.)

Thus, Congress was aware that not all contributions of property to a partnership followed by subsequent distributions should be treated as sales, particularly when contributed property is subject to a liability that was not incurred in anticipation of the contribution or when a deemed distribution occurs as a result of the assumption of liabilities incurred in the ordinary course.

Current Disguised Sale Regulations

Current regulations under section 707 provide rules dealing with disguised sales of property to partnerships.6 The current regulations provide that a transfer of property by a partner to a partnership plus a transfer of money or other consideration by the partnership to the contributing partner (including the assumption of or the taking subject to a liability) is a sale of property, either in whole or in part, by the contributing partner to the partnership if, based on the facts and circumstances, the transfer of money or other consideration by the partnership to the partner would not have been made “but for” the partner’s transfer of property to the partnership, and, if the transfers are not simultaneous, the subsequent transfer does not depend on the entrepreneurial risks of the partnership’s operations.7 A transfer of property to a partnership plus a transfer of money or other consideration to the partner that occur within a two-year period

---

2Staff of JCT, 98th Cong., 2d Sess., at 231.
3This article focuses primarily on the rules found in Treas. reg. sections 1.707-3 and 1.707-5, which are hereinafter referred to as the current regulations.
4Treas. reg. section 1.707-3(b)(1). The current regulations set forth a list of facts and circumstances to be considered in determining whether a sale occurred of a contribution and distribution transaction, including, among others: (a) the existence of a legally enforceable right of the transferor to the subsequent transfer, (b) the existence of any legal obligation of any person to make contributions to the partnership to allow the partnership to transfer money or other consideration to the contributing partner, and (c) any requirement that the partnership incur debt to obtain the funds necessary to allow the partnership to make the distribution (taking into consideration whether the partnership is able to incur that debt and whether any person has assumed personal liability for or agreed to guarantee the debt).
are presumed to be a sale unless clearly established otherwise based on the facts and circumstances surrounding the transfer. There is, however, a presumption against sale treatment if the transfers occur more than two years apart unless the facts and circumstances clearly establish otherwise.

In some circumstances, the assumption of a partner’s liabilities by a partnership will be treated as a distribution of property to that partner by the partnership (a deemed distribution) under the current regulations. Generally, the amount of the deemed distribution depends on whether the liabilities transferred by the contributing partner are “qualified liabilities.” If the partnership assumes or takes property that is subject to a liability that is not a qualified liability of the partner, the partnership will be treated as transferring consideration to the partner in an amount equal to the liability assumed by the partnership over the partner’s share of the liability immediately after the partnership assumes or takes the property subject to the liability.

If, however, a partnership assumes or takes property that is subject to a qualified liability of a partner, the partnership will be treated as transferring consideration to the contributing partner only to the extent provided in regulations. Generally, the partnership’s assumption of (or taking subject to) the qualified liability will not be treated as part of a sale if the transfer of property by the partner to the partnership is not otherwise treated as part of a sale. But if the transfer is treated as part of a sale (independent of the assumption of or taking of the property subject to the qualified liability in connection with the transfer), the partnership’s assumption of (or taking subject to) the qualified liability will be treated as a transfer of consideration to the partner, in a sale, in an amount equal to the lesser of the amount of consideration that would have been treated as transferred to the partner if the liability were not a qualified liability, or an amount equal to the qualified liability multiplied by the contributing partner’s net equity percentage with respect to the contributed property.

A liability that a partnership assumes or takes subject to is treated as a “qualified liability” of a partner only to the extent that the liability is incurred more than two years before the date on which either the partner agrees (in writing) to transfer the property or the partner transfers the property to the partnership (whichever is earlier), provided that the liability has encumbered the transferred property throughout the two-year period; was not incurred in anticipation of the transfer to the partnership, but rather was incurred by the partner within the two-year period before the date on which the partner agrees (in writing) to transfer the property or on which the property is transferred to the partnership (whichever is earlier) and has encumbered the property since it was incurred; is allocable to capital expenditures with respect to the property under the rules of Treas. reg. section 1.163-8T; or was incurred during the ordinary course of a trade or business in which property that was transferred to the partnership was used or held, provided that all the assets relating to the trade or business, other than those that are not material to continuing the trade or business, are transferred. Also, if the liability is a recourse liability, it must not exceed the value of the property (less the amount of other liabilities that are senior and that meet certain other requirements) transferred at the time of the transfer to constitute a qualified liability.

When the current regulations were first proposed, the IRS and Treasury noted Congress’s concern with debt incurred in anticipation of a transfer to a partnership when the partnership assumes the debt, and stated in the preamble to the current regulations as issued in proposed form that “debt incurred more than two years before the transfer (or a written agreement to transfer) and “acquisition or improvement debt or trade payables related to the transferred property” are “never treated as debt incurred in anticipation of the transfer.”

The rules for qualified liabilities provide a necessary exception to disguised sale treatment for bona fide transfers of property to partnerships in which a partnership also assumes a liability or takes property subject to a liability. Otherwise, as the preamble to the proposed regulations suggests, any transfer to a partnership of property subject to a liability could be treated as a disguised sale of property. Assuming a transfer of property is not otherwise treated as a sale, a partner is thus free to transfer property subject to a qualified liability, and a partnership is free to assume a liability in connection with a transfer of property to the partnership, without triggering the disguised sale rules. In keeping

9Treas. reg. section 1.707-3(c)(1). A partner’s share of a partnership’s liability depends on whether the liability is a recourse or nonrecourse liability. A partner’s share of a partnership’s recourse liability is equal to the partner’s share of the liability as determined under section 752 and the regulations thereunder. A partner’s share of a partnership’s nonrecourse liability is determined by applying the same percentage that is used to determine a partner’s share of excess nonrecourse liability under Treas. reg. section 1.752-3(a)(3). If, however, under a plan a partner contributes or pays money to the partnership and one or more liabilities of that partner is assumed by the partnership, the amount of liabilities the partnership is deemed to assume is reduced by the money transferred, but not below zero.

10Treas. reg. section 1.707-3(d).
11Id.
12Treas. reg. section 1.707-5(a)(5).
13Id. A partner’s “net equity percentage” is defined under Treas. reg. section 1.707-5(a)(5)(ii).
14In addition, the current regulations provide that if within a two-year period a partner incurs a liability and either transfers property to a partnership or agrees (in writing) to transfer the property, and the partnership assumes or takes property subject to the liability in connection with the transfer, “the liability is presumed to be incurred in anticipation of a transfer to the partnership, unless facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer.” Treas. reg. section 1.707-5(a)(7)(i).
with the congressional intent of section 707(a)(2)(B), the qualified liability exception to disguised sale treatment, in conjunction with the mechanics of the current regulations, adequately distinguishes between transactions that "attempt to disguise a sale of property" from "non-abusive transactions that accurately reflect the economic contributions of the partners." In creating the qualified liability exception, Treasury was mindful that Congress did not intend to change the general rules under sections 721, 731, and 752 regarding contributed property subject to liabilities that were not incurred in anticipation of the contribution.

Proposed Regulations

Like the current regulations on disguised sales of property to partnerships, the proposed regulations generally provide that a transfer of consideration to a partnership by an acquiring partner plus a transfer of consideration to a selling partner by a partnership will be treated as a sale (in whole or in part) of the selling partner's partnership interest if, based on the facts and circumstances, the partnership's transfer of consideration would not have been made "but for" the acquiring partner's transfer of consideration to the partnership, and, if the transfers are not simultaneous, the subsequent transfer does not depend on the entrepreneurial risks of the partnership's operations. If the transfers are treated as a sale, the selling partner will be deemed to have sold a partnership interest to the acquiring partner with a value equal to the purchasing partner's consideration or the selling partner's consideration (whichever is smaller).

The proposed regulations also provide a list of facts and circumstances to be considered in determining whether those transfers constitute a sale, including those discussed above regarding disguised sales of property to partnerships. Any transfers occurring within two years are presumed to be a sale, and transfers that occur more than two years apart are not presumed to be a sale unless facts and circumstances clearly establish otherwise. Also, deemed transfers resulting from a section 708(b)(1)(B) termination and transfers that are incident to a partnership's formation are disregarded for purposes of determining whether a disguised sale occurs.

Unlike the current regulations, however, the proposed regulations provide that any deemed distributions or deemed contributions resulting from reallocations of partnership liabilities under section 752 will not be treated as transfers of consideration for purposes of the disguised sale rules applicable to partnership interests. If a partnership assumes a partner's liability, under the proposed regulations, the partnership is treated as transferring consideration to the partner in an amount equal to the liability assumed less the partner's share of the liability immediately before the partner assumed the liability. If more than one partner's liabilities are assumed by the partnership, or if more than one partner assumes the partnership's liabilities, the proposed regulations provide special rules to isolate and determine the amount of consideration treated as transferred with respect to each partner. Also, the proposed regulations provide that any relief from liability is included in the amount realized on the sale of a partnership interest by the selling partner.

There is also an overriding antiabuse provision contained in the proposed regulations. Any increase in a partner's share of a partnership's liability may be recharacterized as a transfer of consideration to the partnership by the partner if shortly after the partnership assumes or incurs the liability (or another liability) one or more partners (or parties related to the partner or partners) actually bear a disproportionate amount of the economic risk for the liability as compared to the partner's or partners' profits or capital interest in the partnership, and the transactions occur under a plan that has a principal purpose of minimizing the extent to which the contributing partner is treated as transferring consideration to the partnership that could be treated as part of a sale under the proposed regulations.

A partner's share of a partnership's liability is determined in the same manner as that under the current regulations. The proposed regulations, however, do not provide an exception for qualified liabilities available under the current regulations. In the preamble to the proposed regulations, the IRS and Treasury reasoned that, without the qualified liability exception under the current regulations, "any transfer of property to a partnership subject to a liability could be recharacterized as a disguised sale of property. In contrast, under the proposed regulations, a transfer to a partnership of encumbered property alone would not be subject to recharacterization as a disguised sale of a partnership interest. Rather, a transfer to a partnership of encumbered property would have to be related to a transfer of consideration by another partner in order for disguised sale treatment to apply."

Example 9 of the proposed regulations illustrates how the simultaneous transfers could be recast as a sale, in which a partnership assumes recourse liabilities of a selling partner. A and B each own a 50 percent interest in AB partnership, in which the partners share profits in proportion to their booked-up capital accounts. AB's

Accordingly, A and B each transfer 50 percent of their partnership interests to a separate partnership. AB's liabilities include the liability of $100,000,

22See supra note 7. Like the current regulations, if, under a plan, a partner contributes or pays money to the partnership and one or more liabilities of that partner is assumed by the partnership, the proposed regulations provide that the amount of liabilities the partnership is deemed to assume is reduced by the money transferred, but not below zero. The proposed regulations also add an additional rule: If, under a plan, a partnership distributes or pays money to a partner who assumes one or more of the partnership's liabilities, the amount of liabilities the partner is deemed to assume is reduced by the amount of money transferred, but not below zero.

assets include $100x cash and Orangeacre, which has a fair market value of $860x and is encumbered by a nonrecourse liability of $360x incurred in 1998. The liability, which provides for adequate stated interest, has an issue price of $360x, a term of 10 years, and 100 percent of principal payable at maturity. C contributes $100x to AB and receives an interest in AB. That same day, AB assumes a personal $80x recourse liability of A. As a result, A is released from all liability, and B and C are liable on the $80x recourse liability. There are no facts to rebut the presumption of sale treatment, and the transfers are treated as if A sold a portion of A’s partnership interest to C, because the assumption of A’s liability is treated as a transfer of property to A of $80x. Thus the transfer of C’s $100x to AB and the transfer by AB to A of $80x occur within two years. The value of the partnership interest sold to C is equal to $80x (that is, the lesser of the amount C transferred to AB ($100x) or the amount A received from AB ($80x)). Because the amount A realizes on the sale includes A’s relief from partnership debt, the $47x relief from the partnership’s $360x liability caused by the sale of a portion of A’s interest in AB to C is included in the amount realized by A on the sale.24 Thus, the amount realized by A on the sale of a portion of A’s partnership interest is $127x ($80x + $47x). C is treated as contributing a capital contribution under section 721 to AB partnership equal to $20x ($100 less the $80 used to acquire a portion of A’s interest).

Criticism of Proposed Regulations

If the proposed regulations are finalized without an exception for qualified liabilities, the regulations would create a significant trap for the unwary, particularly in circumstances in which simultaneous transfers do not occur. While the proposed regulations provide that transfers that are not simultaneous will be treated as sales only if the subsequent transfer does not depend on the entrepreneurial risks of partnership operations, that does nothing to ameliorate the problem when recourse debt is assumed by a partnership on the admission of a new partner and that partner is released from liability on the debt.

For example, assume that in year 1 two individuals, D and E, form partnership DE for the purpose of making widgets, each contributing $100 to DE. F and G, two individuals with experience in making widgets, each contribute $70 to the DE partnership. In year 2, F joins DE by contributing land with a fair market value of $190 and a recourse liability of $60 which was incurred two years before the date on which F agreed to transfer the property and has encumbered the property since that time. DE agrees to assume F’s liability for the land because F would not agree to join DE unless either DE agreed to assume the liability (with F being released from and D and E becoming ultimately liable for the debt) or D and E each contributed an additional $30 to DE. In year 3, G contributes $130 to the partnership. Absent an exception for qualified liabilities, the entire transaction could be recast as a sale by F of a portion of his partnership interests to G. Before the transaction, F was liable for $60 of the recourse liability, and after the transaction, F was released from the entire $60 liability. Thus, without sufficient proof to rebut the presumption, F realizes an amount equal to $60 on the purported sale of a portion of his respective partnership interest to G. G is treated as purchasing a portion of his partnership interest equal to $60 and as making a contribution of $70 to the partnership in exchange for a partnership interest under section 721.

That result is unfair and highly counterintuitive. Had D, E, F, and G formed a partnership in year 1, the disguised sale rules would not have applied to treat F as selling a portion of his partnership interest. F should not be treated as selling, and G should not be treated as buying, a portion of F’s partnership interest simply because the contributions took place in later years. Moreover, F did not engage in any wrongdoing by simply having a pre-existing liability on the property contributed to the partnership and should not be penalized simply because he decided to join a venture by contributing property subject to a liability.

Even after partnerships are formed, partners often contribute property to partnerships and admit new partners. A partner should not be penalized simply because he has only property subject to a liability not incurred in anticipation of the transaction to contribute. A presumption, although rebuttable, can create myriad practical problems that could cause unnecessary litigation and expense. Providing an exception to disguised sale treatment for qualified liabilities in transactions not otherwise treated as a sale would alleviate much of the burden imposed by the proposed regulations as currently drafted. If the qualified liability exception were to have applied in the above example, no disguised sale treatment would result. Thus, an unwary partner in a partnership who contributes encumbered property to a partnership would be protected from that unfortunate result.

Moreover, a qualified liability exception would address Congress’s caution regarding overreaching regulations. It is clear from the legislative history to section 707(a)(2)(B) that Congress was concerned with transactions in which debt assumed by the partnership was incurred in anticipation of a contribution to a partnership, but did not intend to change the general nonrecognition provisions under sections 721, 731, and 752.25 As noted by the IRS and Treasury in the preamble to the current regulations (as issued in proposed form), some categories of debt, which fall within the definition of qualified liabilities (that is, debt that is incurred more than two years before a transfer (or an agreement in writing to transfer), improvement or acquisition debt and trade payables related to the property transferred) are “never treated as debt incurred in anticipation of the transfer.” If that debt is in fact never treated as debt

24Before the sale of a portion of A’s partnership interest, A’s share of AB’s $360x nonrecourse liability was $180x (or 50 percent). After the sale, A’s share of AB’s $360 nonrecourse liability is $133x. Thus A’s share of AB’s nonrecourse liability is reduced by about $47x as a result of the sale.

25See Staff of JCT, 98th Cong., 2d Sess., at 231.
incurred in anticipation of a transfer, and Congress was concerned with transactions in which debt is incurred in anticipation of a contribution to a partnership, there appears to be no harm in including within the proposed regulations an exception for those qualified liabilities. If, however, the IRS and Treasury are wary about creating an exception for all debt that is treated as a qualified liability under the current regulations, the qualified liability exception under the proposed regulations could be limited to those categories of debt specifically referred in the parenthetical above.

It may be that the IRS and Treasury were concerned with transactions in which a partnership assumes a partner’s stand-alone debt that is unrelated to the property contributed to the partnership, and example 9 of the proposed regulations reflects such a situation. Indeed, such an assumption of stand-alone debt may be equivalent to a distribution of cash or other property to the partner that in many instances should trigger the presumption for disguised sale treatment to prevent abusive transactions. A qualified liability, however, appears to include only liabilities that are inherently related to contributed property. If, however, the IRS and Treasury are concerned that a qualified liability could include stand-alone liabilities, a solution to prevent disguised sales that occur as a result of the assumption by a partnership of a partner’s stand-alone liability could be to define “qualified liability” specifically to include only liabilities that are related or attached to the property contributed to the partnership.

The IRS and Treasury may also have considered that a qualified liability exception was unnecessary because of the rule under the proposed regulations that deemed distributions and contributions resulting from reallocation of partnership liabilities are not treated as transfers of consideration for purposes of the disguised sale rules. While that rule may protect against disguised sale treatment for the reallocation of pre-existing partnership liabilities, it does not appear to protect a partner who contributes property subject to a nonrecourse liability that is assumed by the partnership. The exception for reallocations of liabilities refers only to partnership liabilities that are reallocated among the partners and not to partners’ liabilities that are assumed by the partnership. In other words, the exception appears to deal with reallocations only under section 752(a) and not section 752(b). Thus, a partner could be treated as receiving a transfer of money or other consideration from the partnership if the partnership agrees to assume property subject to a liability.

While a partnership’s assumption of a partner’s recourse liability could create potential for abuse, it is unclear what is being protected when a partnership assumes a partner’s nonrecourse liability. Mortgages on real property are not uncommon, and a partner should not be subject to a presumption of disguised sale treatment simply because the partner joined an existing partnership by contributing property subject to a nonrecourse liability and within two years before or after that partner’s admission, another person contributed property to the partnership. If the partner is not ultimately liable on the liability regardless of whether the liability was assumed by the partnership, it is unclear how the partner economically benefits when the partnership receives the property subject to the liability. And, when the nonrecourse liability falls within the definition of a qualified liability, the application of disguised sale rules to partnership interests without a qualified liability exception seem even less defensible.

Finally, the antiabuse provisions available under the proposed regulations provide sufficient grounds for the IRS to challenge transactions the IRS believes are offensive. Thus, regardless of whether liabilities transferred by a partner to a partnership fall within the definition of qualified liabilities the overriding antiabuse provision contained in proposed Treas. reg. section 1.707-7(j)(8) could recharacterize an increase in any partner’s share of a partnership’s liabilities as a transfer of consideration by a partner to the partnership. If the IRS and Treasury are concerned about transfers of liabilities by a partner to a partnership, the antiabuse provision could provide that a partner’s relief from liabilities may be recharacterized as a transfer of consideration by the partnership to the partner if requirements similar to those contained under the antiabuse provisions under the proposed regulations are met.

Conclusion

Without an exception for qualified liabilities, the proposed regulations do not distinguish between “nonabusive transactions that accurately reflect the economic contributions of the partners” from those that “attempt to disguise a sale of property.” Congress had no intention of changing the tax treatment of partners under sections 721, 731, and 752 when property subject to a liability that was not incurred in anticipation of the contribution is contributed to a partnership. If Treasury thought it appropriate to except qualified liabilities from the disguised sale treatment for property, the same exception should also apply to disguised sale treatment for partnership interests. Without an exception for qualified liabilities, the proposed regulations are overreaching and produce unjust results.

A qualified liability exception similar to that under the current regulations would ameliorate much of that burden. Thus, a partner who contributes property subject to a liability incurred in a trade or business that meets the definition of a qualified liability would generally not need to be concerned that his contribution could be recharacterized as a sale of a partnership interest when a subsequent partner is admitted, unless the entire transaction was abusive. However, any liabilities that are not qualified liabilities could still fall within the general rule and thus be subject to scrutiny by the IRS.