Commentary
Unneeded Reform

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Professor Gergen proposes a highly complicated restructuring of sub-chapter K’s distribution rules. The justification is that existing law does not adequately police disguised sales and income shifting arrangements. His goal is to do a better job, with no worse complexity, while preserving the two legitimate objectives of tax-free contributions and distributions: avoiding double taxation of partnership earnings and preventing a tax disincentive to invest in partnerships.

I. THE PROBLEM?

In Section II of his article, Professor Gergen illustrates five instances of improper deferral or income shifting that his proposal would check. Most of the illustrations, however, are vulnerable under current law that he later criticizes as being inadequate: § 704(c), the regulations under § 704(b) and regulations on disguised sales under § 707(a)(2)(B). And those that are less vulnerable under existing law either are not compelling cases or could be checked by minor changes in the law.

Example 1 is a contribution of property by one partner followed by a distribution to another at least two years later. The conclusion is that this would probably survive attack under the disguised sale regulations. Maybe, maybe not; that is what the disguised sale regulations are intended to sort out. Professor Gergen is uneasy relying on the regulations because he finds them unacceptably uncertain, a subject I address below. Two actual transactions are cited as evidence of the problem, but each is

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2 Id. at 176-80.
3 IRC § 704(c); Reg. § 1.704-1; Reg. §§ 1.707-3 to -9.
4 Gergen, note 1, at 176.
5 Id.
6 Id. at 187-90.
conceded to be affected by § 704(c)(1)(B) or the disguised sale regulations.  

Example 2 is a contribution of cash to a partnership with an appreciated asset ("reverse" built-in gain) where the preexisting partners' accounts are not marked up, followed by a sale of the asset and proportionate (that is, non-§ 704(c)) sharing of the gain. Upon liquidation of the preexisting partners' interests, the partnership pays them a guaranteed payment, chargeable to the cash partner's account, in an amount equal to the built-in gain inappropriately allocated to the cash partner. If all this is respected, the advantage is a shift of income from the preexisting partners to the cash partner for the period between the sale of the asset and liquidation of the preexisting partners, which is detrimental to the fisc only if the cash partner is in a lower bracket than the preexisting partners.

Even a cavalier advisor would see acute risk here. For what is the guarantee given? What capital or services have the preexisting partners provided to earn the guarantee? The only apparent explanation is that the guarantee offers a formal escape from both § 704(c) and the core § 704(b) requirement that capital accounts must govern the partners' economic entitlements. Moreover, the regulations caution that § 704(b) allocations inconsistent with § 704(c), facilitated by a decision not to mark up capital accounts on admission of the cash partner, will be scrutinized in order to determine other appropriate consequences.

How could the transaction in Example 2 survive such scrutiny?

Example 3 is a contribution of low-basis property to a partnership that owns property with a fair market value basis, followed by a distribution...
of a portion of the full-basis property to the low-basis contributor.\textsuperscript{13} The complaint here is that the partnership’s failure to make a § 754 election shifts the low-basis contributor’s built-in gain to the preexisting partners (which duplicates the low-basis contributor’s built-in gain reflected in the stepped-down distributed property).\textsuperscript{14} Conversely, failure to elect would benefit preexisting partners with built-in gain where low-basis property was distributed to a high-basis contributor. However, if, for example, distribution of low-basis property to a high-basis contributor by a partnership not electing under § 754 were caught by the disguised sale regulations, the step up of inside basis would be accompanied by income to the remaining partners.\textsuperscript{15} As to those distributions sufficiently distant in time to survive attack as a disguised sale, mandatory § 734(b) adjustments, as proposed by Professor William Andrews,\textsuperscript{16} would solve the problem. Finally, new § 737 would tax the contributing partner’s built-in gain where the contribution and distribution are less than five years apart.

\textit{Example 4} is a disguised compensation arrangement where an employer contributes its stock to a partnership formed with an employee.\textsuperscript{17} The employee is entitled to a share of future appreciation in the stock, distributable in the form of the stock itself. The alleged problem is that the employee arguably can include the profits interest as income upon receipt at a low value and under § 731 have no further income when the stock is distributed, no matter how valuable the stock is at that time. Only when the stock is sold will the appreciation be taxed. The economic equivalent could be achieved with the same tax results under § 83(b) without using a partnership. Thus, it is hard to blame this problem on subchapter K. Moreover, where a partnership is employed, the Eighth Circuit’s decision in \textit{Campbell}\textsuperscript{18} would imply serious question as to whether the profits interest is taxable on receipt. Finally, the arrangement begs for characterization as a simple case of disguised compensation, taxable on receipt of the stock under § 707(a).

\textit{Example 5} is the well-publicized arrangement\textsuperscript{19} in which sequential artificial gains and losses (created by the straight-line basis recovery rules

\begin{itemize}
\item \textsuperscript{13} Id. at 179.
\item \textsuperscript{14} This could never hurt the government; a § 754 election in this circumstance prevents a windfall to the government by stepping up the basis of the contributed asset and thereby preventing duplication of built-in gain in both the contributed and distributed assets.
\item \textsuperscript{15} See Reg. §§ 1.707-3, -6.
\item \textsuperscript{17} Gergen, note 1, at 179.
\item \textsuperscript{18} Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991), aff’d in part and rev’d in part 59 T.C.M. (CCH) 236 (1990).
\item \textsuperscript{19} See IRS Notice 90-56, 1990-2 C.B. 344, where the Service specifically warned, among other things, that the allocations may not satisfy § 704(b).
\end{itemize}
applicable to contingent payment sales payable over a maximum period of time) are allocated in a manner such that partners remaining after the major partner is redeemed are allocated all of the artificial losses, notwithstanding that they were allocated only a small part (due to the then presence of the major partner) of the previous artificial gains. The reversal need not occur until the partnership is liquidated, which might be years later. My problem with this example is similar to the problem I have with Example 2: The redeemed partner cannot be allocated gain that he will not take with him on liquidation. Allocation of artificial gain to the redeemed partner would be valid under § 704(b) only if the subsequent distribution matched his capital account, which would not occur unless the redeemed partner's account was marked down to eliminate the artificial gain. Such a markdown requires a "substantial non-tax business purpose," which obviously is missing here. Professor Gergen admits that the transaction is vulnerable on this point.

II. INADEQUACY OF EXISTING RULES

Professor Gergen finds weaknesses in § 704(c), in the disguised sale regulations and in the § 704(b) regulations regarding reverse built-in gain. He dislikes § 704(c) in general because it is subject to the ceiling rule and § 704(c)(1)(B) in particular because it does not apply to distributions of property contributed more than five years before. The ceiling rule is a nuisance, but it hardly warrants rewriting subchapter K on a mandatory basis. Section 704(c)(1)(B) has recently been extended to a distribution to the contributing partner. Whether a redemption of the contributing partner and distributions separated from contributions by more than five years should trigger built-in gain is precisely the type of issue the disguised sale rules have addressed.

The § 704(b) regulations do not trigger reverse built-in gain inherent in partnership assets on a distribution of the assets to other partners or on a redemption of the partner to whom the built-in gain would be allocable under § 704(c) principles. There are good reasons for not subjecting as-

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21 Gergen, note 1, at 180-81 n. 28.
22 My views on these issues are in John P. Steines, Jr., Partnership Allocations of Built-in Gain or Loss, 45 Tax L. Rev. 615 (1990).
23 Gergen, note 1, at 183-84.
24 Id. at 184.
25 The Revenue Bill of 1992, H.R. 11, 102d Cong., 2d Sess., § 4301 would have effectively repealed the ceiling rule for large partnerships (that is partnerships with 250 or more partners, or partnerships with 100 or more partners electing to be treated as large partnerships) by imposing a deferred sale approach.
sets with reverse gain to the five-year distribution rule of § 704(c)(1)(B). The practical effect would be to subject all distributions to the rule, triggering reverse gain with every property distribution, for partnerships that receive contributions at least once every five years. The disguised sale rules would be a much less pervasive means of handling abuse in this area.

Professor Gergen’s deepest complaint is aimed at the disguised sale rules. Essentially, he is troubled that the factors recited by the regulations as indicative of a sale—shortness of time, absence of risk and payout from capital instead of profits27—do not necessarily distinguish transactions that should be taxed from those that should not be.28 Because risk seems the most important factor in the regulations, he is dissatisfied with the uncertainty that results from not knowing how much risk is sufficient. As a consequence, he favors purely mechanical rules that leave nothing in doubt.29 However, the last 10 years of increasingly complex mechanical approaches in the Code and regulations indicate that certainty does not necessarily accompany mechanical rules. If the rules are inaccessible, because they are either too difficult to understand or not worth the taxpayer’s investment to try to understand, they will not bring certainty. Beyond that, taxation, like any other field of law, cannot be purged of judgment calls. A rule that depends on facts and circumstances is not inherently defective. Indeed, a modest dose of uncertainty is healthy in that it keeps most taxpayers from getting too close to the line.

27 See Reg. §§ 1.707-3(b), (c), (d), -4(a), (b).
28 Gergen, note 1, at 187.
29 On a more technical level, Professor Gergen raises two deficiencies with the disguised sale regulations. I agree with him that the regulations do not reach a disguised sale of assets with reverse built-in gain unless the reverse-gain asset is distributed to the partner who has “purchased” it, which usually would not be the case unless the distributee has made a contribution within two years of the date of the distribution. See Steines, note 22, at 675. If the § 704(b) regulations do not reach swaps of assets with reverse gain, the disguised sale regulations probably should.

His second point is that imputed interest (for example, under § 1274) on contribution/distribution transactions might escape tax altogether with respect to those years barred by the statute of limitations where the transaction is belatedly characterized as a disguised sale. See Steines, note 22, at 674 n.206. However, subsequent payment of such time-barred interest should give rise to a § 705(a)(2)(B) adjustment to the “purchasing” partners, which would permanently eliminate the tax benefit from the time-barred interest deduction, and hence, have the effect of offsetting the time-barred interest income (though perhaps with a different character, and without compensation for any rate differential between buyer and seller). Alternatively, the basis adjustment might occur when the interest accrues under § 705 generally, on the theory that basis must be charged for the interest deduction even though no tax benefit was claimed. A similar analysis probably would not apply to the principal component of a belatedly characterized disguised sale of property that does not qualify for the installment method. In other words, the purchaser probably would have a cost basis even though taxation of the seller’s gain is time barred. The mitigation provisions of § 1311 might bear on these questions.
III. The Proposal

Professor Gergen's proposal has three major components:

1. Assets would be marked up (or down) to current value on every non-pro rata contribution or distribution and the resulting built-in gain or loss would be allocated provisionally among the partners according to § 704(c) principles.

2. Gain or loss inherent in distributed partnership assets would be recognized by the partnership on distribution, like the § 311(b) rule for corporations, and allocated according to the first rule.

3. On a distribution of property, the distributee partner would recognize the value of the property as income to the extent of the remaining unrealized gain in his partnership interest.

The first two rules represent a full expansion of § 704(c), bereft of all the alleged defects of current law. The rules would apply to reverse built-in items as well as built-in items in contributed assets, and they would apply to distributions occurring five or 500 years after the built-in gain is provisionally marked up. The third rule would treat every distribution as a sale of the distributee's partnership interest as of the distribution, thus obviating § 707(a)(2)(B), but with the additional sting of back-loaded basis recovery in nonliquidating distributions, and without regard to how long it has been since the distributee last contributed anything to the partnership.

Like existing §§ 704(c)(1)(B) and 751(b), the second rule has an exception (comprising four additional rules) for property distributed to the partner to whom the previously untaxed gain would be allocated. The third rule is subject to exceptions for distributions out of the distributee's previously taxed partnership income, contributed cash (and basis of contributed property that the partnership has sold prior to the distribution), and share of partnership debt (two or possibly three more accounts). These exceptions are designed to make sure that the proposal does not double tax income temporarily or, at least in some cases, accelerate taxation in advance of when it would occur outside of a partnership.

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30 The proposal claims to eliminate the need for §§ 707(a)(2)(B), 751(b) and 734(b). Also, it is intended to complement, but is not dependent on, the author's separate proposal to prohibit allocations that are not strictly in proportion to capital. See Mark P. Gergen, Reforming Subchapter K: Special Allocations, 46 Tax L. Rev. 1 (1990).

31 See Gergen, note 1, at 225-29.

32 Id. at 213-14.

33 Id. at 223-24.

34 Id. at 229-37.
setting. But they result in exceeding complexity: a thicket of rules and a multitude of accounts that could be justified only as a response to a truly grave problem not susceptible to simpler correction.

Despite all the complexity, the rules are unnecessarily harsh, approximating a hybrid closer to subchapter C than subchapter S (at least in nonliquidating distributions). Consider the following examples that illustrate the reach of the proposal:

**Example 1:** A, B and C each contribute $100 cash to a partnership that uses the money to purchase nonfungible operating assets (ignore depreciation). The partners withdraw current earnings annually and 10 years later, when C decides to withdraw, the assets have multiplied tenfold in value. C withdraws, taking $1,000 of operating assets from the partnership.

Under Professor Gergen’s proposed rules, A and B would have $600 of income between them and C would have another $600 of income.

**Example 2:** Same as **Example 1**, except that C takes only $500 worth of property in liquidation of half of his interest.

Under the proposed rules, A and B would have $300 of income between them and C would have another $333 of income.

**Example 3:** A contributes $100 cash and B and C each contribute investment real estate with a zero basis and $100 value. The assets do not change in value for 10 years. At the end of 10 years, C withdraws taking the parcel contributed by B.

Under the proposed rules, B and C each would have $100 of income; in effect, this would be treated as a taxable like kind exchange.

**IV. Overall Evaluation**

I regard the proposal as an overreaction to a small problem. Subchapter K is not an impenetrable tax-avoidance machine that, as the proposal suggests, must be throttled at any cost. Most of the perceived abuses have been addressed adequately by the disguised sale rules and the recent expansion of § 704(c)(1)(B) to redemptions of the contributing partner, without plaguing every partnership, not to mention the government, with the expense and aggravation of coping with a geometric increase in the complexity of subchapter K. I am astonished by the claim that the proposal is no more complex than current law and would not be a disincentive to the use of partnerships. And I suspect that the proposal would not ensnare sufficiently more abusive cases than existing law to justify its existence.