

the partnership allocations were designed to effect an exchange of the burdens and benefits of ownership of the government securities in anticipation of the transfer of those securities to I and those burdens and benefits were effectively shifted to I on formation of the partnership. Accordingly, the facts and circumstances clearly establish that I sold the office building to the partnership on February 1, 1992, in exchange for the partnership's obligation to transfer the government securities to I and to make certain other cash transfers to I.

[T.D. 8439, 57 FR 44978, Sept. 30, 1992]

§ 1.707-4 Disguised sales of property to partnership; special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation expenditures.

(a) *Guaranteed payments and preferred returns*—(1) *Guaranteed payment not treated as part of a sale*—(i) *In general*. A guaranteed payment for capital made to a partner is not treated as part of a sale of property under § 1.707-3(a) (relating to treatment of transfers as a sale). A party's characterization of a payment as a guaranteed payment for capital will not control in determining whether a payment is, in fact, a guaranteed payment for capital. The term *guaranteed payment for capital* means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital. See section 707(c). For this purpose, one or more payments are not made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership.

(ii) *Reasonable guaranteed payments*. Notwithstanding the presumption set forth in § 1.707-3(c) (relating to transfers made within two years of each other), for purposes of section 707(a)(2) and the regulations thereunder a transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital, is determined without regard to the income of the partnership and is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed to be a guaranteed payment for capital unless the facts

and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iii) *Unreasonable guaranteed payments*. A transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital but that is not reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is a guaranteed payment for capital. A transfer that is not a guaranteed payment for capital is subject to the rules of § 1.707-3.

(2) *Presumption regarding reasonable preferred returns*. Notwithstanding the presumption set forth in § 1.707-3(c) (relating to transfers made within two years of each other), a transfer of money to a partner that is characterized by the parties as a preferred return and that is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be part of a sale of property to the partnership unless the facts and circumstances (including the likelihood and expected timing of the subsequent allocation of income or gain to support the preferred return) clearly establish that the transfer is part of a sale. The term *preferred return* means a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain.

(3) *Definition of reasonable preferred returns and guaranteed payments*—(i) *In general*. A transfer of money to a partner that is characterized as a preferred return or guaranteed payment for capital is reasonable only to the extent that the transfer is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.

(ii) *Reasonable amount*. A transfer of money that is made to a partner during any partnership taxable year and is

characterized as a preferred return or guaranteed payment for capital is reasonable in amount if the sum of any preferred return and any guaranteed payment for capital that is payable for that year does not exceed the amount determined by multiplying either the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid preferred return or guaranteed payment for capital that is payable to the partner) by the safe harbor interest rate for that year. The safe harbor interest rate for a partnership's taxable year equals 150 percent of the highest applicable Federal rate, at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year. A partner's unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than transfers of money that are presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, transfers of money that are reasonable preferred returns within the meaning of this paragraph (a)(3), and operating cash flow distributions within the meaning of paragraph (b)(2) of this section.

(4) *Examples.* The following examples illustrate the application of paragraph (a) of this section:

Example 1. Transfer presumed to be a guaranteed payment. (i) A transfers property with a fair market value of \$100,000 to partnership AB. At the time of A's transfer, the partnership agreement is amended to provide that A is to receive a guaranteed payment for the use of A's capital of 10 percent (compounded annually) of the fair market value of the transferred property in each of the three years following the transfer. The partnership agreement provides that partnership net tax-

able income and loss will be allocated equally between partners A and B, and that partnership cash flow will be distributed in accordance with the allocation of partnership net taxable income and loss. The partnership would be allowed a deduction in the year paid if the transfers made to A are treated as guaranteed payments under section 707(c). Under the partnership agreement, that deduction would be allocated in the same manner as any other item of partnership deduction. The partnership agreement complies with the requirements of § 1.704-1(b)(2)(ii)(b). The partnership agreement does not provide for the payment of a preferred return and, other than the guaranteed payment to be paid to A, no transfer is expected to be made during the three year period following A's transfer that is not an operating cash flow distribution (within the meaning of paragraph (b)(2) of this section). Assume that the highest applicable Federal rate in effect at the time of A's transfer is eight percent compounded annually.

(ii) The transfer of money to be made to A under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of § 1.707-4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in § 1.707-3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital but is part of a sale.

(iii) The presumption that the transfer is a guaranteed payment for capital is not rebutted, because there are no facts indicating that the transfer is not a guaranteed payment for the use of capital.

Example 2. Transfers characterized as guaranteed payments treated as part of a sale. (i) C and D form partnership CD. C transfers property with a fair market value of \$100,000 and an adjusted tax basis of \$20,000 in exchange for a partnership interest. D is responsible for managing the day-to-day operations of the partnership and makes no capital contribution to the partnership upon its formation. The partnership agreement provides that C is to receive payments characterized as guaranteed payments and determined without regard to partnership income of \$8,333 per year for the first four years of partnership operations for the use of C's capital. In addition, the partnership agreement provides that—

(A) Partnership net taxable income and loss will be allocated 75 percent to C and 25 percent to D; and

(B) All partnership cash flow (determined prior to consideration of the guaranteed payment) will be distributed 75 percent to C and 25 percent to D except that guaranteed payments that the partnership is obligated to make to C are payable solely out of D's share of the partnership's cash flow.

(ii) If D's share of the partnership's cash flow is not sufficient to make the guaranteed payment to C, then D is obligated to contribute any shortfall to the partnership, even in the event the partnership is liquidated. Thus, the effect of the guaranteed payment arrangement is that the guaranteed payment to C is funded entirely by D. The partnership agreement complies with the requirements of § 1.704-1(b)(2)(ii)(b). Assume that, at the time the partnership is formed, the partnership or D could borrow \$25,000 pursuant to a loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of approximately 12 percent (compounded annually). Assume that the highest applicable Federal rate in effect at the time the partnership is formed is 10 percent compounded annually.

(iii) The transfer of money to be made to C under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of § 1.707-4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in § 1.707-3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iv) For the first four years of partnership operations, the total guaranteed payments made to C under the partnership agreement will equal \$33,332. If the characterization of those payments as guaranteed payments for capital within the meaning of section 707(c) were respected, C would be allocated \$24,999 of the deductions that would be claimed by the partnership for those payments, thereby leaving the balance in C's capital account approximately \$25,000 less than it would have been if the guaranteed payments had not been made. The guaranteed payments thus have the effect of offsetting approximately \$25,000 of the credit made to C's capital account for the property transferred to the partnership by C. C's resulting capital account is approximately equivalent to the capital account C would have had if C had only contributed 75 percent of the property to the partnership. Furthermore, the effect of D's funding the guaranteed payment to C (either through reduced distributions of cash flow to D or additional contributions) is that

D's capital account is approximately equivalent to the capital account D would have had if D had contributed 25 percent of the property (or contributed cash so that the partnership could purchase the 25 percent). Moreover, a \$25,000 loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of 12 percent (compounded annually), would have resulted in annual payments of principal and interest of \$8,230.86. Consequently, the guaranteed payments effectively place the partners in the same economic position that they would have been in had D purchased a one-quarter interest in the property from C financed at the current market rate of interest, and then C and D each contributed their share of the property to the partnership. In view of the burden the guaranteed payments place on D's right to transfers of partnership cash flow and D's legal obligation to make contributions to the partnership to the extent necessary to fund the guaranteed payments, D has effectively purchased through the partnership a one-quarter interest in the property from C.

(v) Under these facts, the presumption that the transfers to C are guaranteed payments for capital is rebutted, because the facts and circumstances clearly establish that the transfers are part of a sale and not guaranteed payments for capital. Under § 1.707-3(a), C and the partnership are treated as if C sold a one-quarter interest in the property to the partnership in exchange for a promissory note evidencing the partnership's obligation to make the guaranteed payments.

(b) *Presumption regarding operating cash flow distributions—(1) In general.* Notwithstanding the presumption set forth in § 1.707-3(c) (relating to transfers made within two years of each other), an operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale.

(2) *Operating cash flow distributions—*

(i) *In general.* One or more transfers of money by the partnership to a partner during a taxable year of the partnership are operating cash flow distributions for purposes of paragraph (b)(1) of this section to the extent that those transfers are not presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, are not reasonable preferred returns within the meaning of paragraph (a)(3) of this section, are not characterized by the parties as distributions to the partner acting in a capacity other than as a

partner, and to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner's percentage interest in overall partnership profits for that year or the partner's percentage interest in overall partnership profits for the life of the partnership. For purposes of the preceding sentence, the net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership's business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by—

(A) Principal payments made on any partnership indebtedness;

(B) Property replacement or contingency reserves actually established by the partnership;

(C) Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow; and

(D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

(ii) *Operating cash flow safe harbor.* For any taxable year, in determining a partner's operating cash flow distributions for the year, the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year. This provision is merely intended to provide taxpayers with a safe harbor and is not intended to preclude a taxpayer from using a different percentage under the rules of paragraph (b)(2)(i) of this section.

(iii) *Tiered partnerships.* In the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership applying principles similar to those described in paragraph (b)(2)(i) of this section, so that the amount of the upper-tier partnership's operating cash

flow distributions is neither overstated nor understated.

(c) *Accumulation of guaranteed payments, preferred returns, and operating cash flow distributions.* Guaranteed payments for capital, preferred returns, and operating cash flow distributions presumed not to be part of a sale under the rules of paragraphs (a) and (b) of this section do not lose the benefit of the presumption by reason of being retained for distribution in a later year.

(d) *Exception for reimbursements of preformation expenditures.* (1) *In general.* 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) (relating to treatment of transfers as a sale) 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—

(i) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and

(ii) Are incurred by the partner with respect to—

(A) Partnership organization and syndication costs described in section 709; or

(B) Property transferred 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 such property at the time of the transfer (the 20-percent limitation). However, the 20-percent limitation of this paragraph (d)(1)(ii)(B) does not apply if the fair market value of the transferred property does not exceed 120 percent of the partner's adjusted basis in the transferred property at the time of the transfer (the 120-percent test). This paragraph (d)(1)(ii)(B) shall be applied on a property-by-property basis, except that a partner may aggregate any of the transferred property under this paragraph (d)(1) to the extent—

(1) The total fair market value of such aggregated property (of which no single property's fair market value exceeds 1 percent of the total fair market value of such aggregated property) is not greater than the lesser of 10 percent of the total fair market value of

all property, excluding money and marketable securities (as defined under section 731(c)), transferred by the partner to the partnership, or \$1,000,000;

(2) The partner uses a reasonable aggregation method that is consistently applied; and

(3) Such aggregation of property is not part of a plan a principal purpose of which is to avoid §§1.707-3 through 1.707-5.

(C) [Reserved].

(2) *Capital expenditures incurred by another person.* For purposes of paragraph (d)(1) of this section, a partner steps in the shoes of a person (to the extent the person was not previously reimbursed under paragraph (d)(1) of this section) with respect to capital expenditures the person incurred with respect to property transferred to the partnership by the partner to the extent the partner acquired the property from the person in a nonrecognition transaction described in section 351, 381(a), 721, or 731.

(3) *Contribution of a partnership interest with capital expenditures property.* If a person transfers property with respect to which the person incurred capital expenditures (capital expenditures property) to a partnership (lower-tier partnership) and, within the two-year period beginning on the date upon which the person incurred the capital expenditures, transfers an interest in the lower-tier partnership to another partnership (upper-tier partnership) in a nonrecognition transaction under section 721, the upper-tier partnership steps in the shoes of the person who transferred the capital expenditures property to the lower-tier partnership with respect to the capital expenditures that are not otherwise reimbursed to the person. The upper-tier partnership may be reimbursed by the lower-tier partnership under paragraph (d)(1) of this section to the extent the person could have been reimbursed for the capital expenditures by the lower-tier partnership under paragraph (d)(1) of this section. In addition, for purposes of paragraph (d)(1) of this section, the person is deemed to have transferred the capital expenditures property to the upper-tier partnership and may be reimbursed by the upper-tier partnership under paragraph (d)(1) of this section to the extent the person

could have been reimbursed for the capital expenditures by the lower-tier partnership under paragraph (d)(1) of this section and has not otherwise been previously reimbursed. The aggregate reimbursements for capital expenditures under this paragraph (d)(3) shall not exceed the amount that the person could have been reimbursed for such capital expenditures under paragraph (d)(1) of this section.

(4) *Special rule for qualified liabilities—*

(i) *In general.* For purposes of paragraph (d)(1) of this section, if capital expenditures were funded by the proceeds of a qualified liability defined in §1.707-5(a)(6)(i) that a partnership assumes or takes property subject to in connection with a transfer of property to the partnership by a partner, a transfer of money or other consideration by the partnership to the partner is not treated as made to reimburse the partner for such capital expenditures to the extent the transfer of money or other consideration by the partnership to the partner exceeds the partner's share of the qualified liability (as determined under §1.707-5(a)(2), (3), and (4)). Capital expenditures are treated as funded by the proceeds of a qualified liability to the extent the proceeds are either traceable to the capital expenditures under §1.163-8T or were actually used to fund the capital expenditures, irrespective of the tracing requirements under §1.163-8T.

(ii) *Anti-abuse rule.* If capital expenditures and a qualified liability are incurred under a plan a principal purpose of which is to avoid the requirements of paragraph (d)(4)(i) of this section, the capital expenditures are deemed funded by the qualified liability.

(5) *Scope of capital expenditures.* For purposes of this section and §1.707-5, the term *capital expenditures* has the same meaning as the term *capital expenditures* has under the Internal Revenue Code and applicable regulations, except that it includes capital expenditures taxpayers elect to deduct, and does not include deductible expenses taxpayers elect to treat as capital expenditures.

(6) *Example.* The following example illustrates the application of paragraph (d) of this section:

Example. Intangible treated as separate property. (i) Z transfers to a partnership a business the material assets of which include a tangible asset and goodwill from the reputation of the business. At the time Z transfers the business to the partnership, the tangible asset has a fair market value of \$550,000 and an adjusted basis of \$450,000. The goodwill is a section 197 intangible with a fair market value of \$100,000 and an adjusted basis of \$0. Z incurred \$130,000 of capital expenditures with respect to improvements to the tangible asset (which amount is reflected in its adjusted basis) one year preceding the transfer. Z would like to be reimbursed by the partnership for the capital expenditures with an amount that qualifies for the exception for reimbursement of preformation expenditures under paragraph (d)(1) of this section.

(ii) Under paragraph (d)(1)(ii)(B) of this section, the 20-percent limitation on reimbursed capital expenditures applies on a property-by-property basis. The 120-percent test also applies on a property-by-property basis. Accordingly, the tangible asset and the goodwill each constitutes a separate property. Z incurred the capital expenditures with respect to the tangible asset only. The \$550,000 fair market value of the tangible asset exceeds 120 percent of Z's \$450,000 adjusted basis in the asset at the time of the transfer (120 percent \times \$450,000 = \$540,000). Thus, the 20-percent limitation applies so that the reimbursement of Z's \$130,000 of capital expenditures is limited to 20 percent of the fair market value of the tangible asset, or \$110,000 (20 percent \times \$550,000).

(e) *Other exceptions.* The Commissioner may provide by guidance published in the Internal Revenue Bulletin that other payments or transfers to a partner are not treated as part of a sale for purposes of section 707(a)(2) and the regulations thereunder.

(f) *Ordering rule cross reference.* For payments or transfers by a partnership to a partner to which the rules under this section and § 1.707-5(b) apply, see the ordering rule under § 1.707-5(b)(3).

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§ 1.707-5 Disguised sales of property to partnership; special rules relating to liabilities.

(a) *Liability assumed or taken subject to by partnership—(1) In general.* For purposes of this section and §§ 1.707-3 and 1.707-4, if a partnership assumes or takes property subject to a qualified liability (as defined in paragraph (a)(6) of this section) of a partner, the part-

nership is treated as transferring consideration to the partner only to the extent provided in paragraph (a)(5) of this section. 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 paragraphs (a) (2), (3) and (4) of this section.

(2) [Reserved]. For further guidance, see § 1.707-5T(a)(2).

(3) *Reduction of partner's share of liability.* For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes property subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if—

(i) At the time that the partnership assumes or takes property subject to the liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced;

(ii) The anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and

(iii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking property subject to the liability is treated as part of a sale under § 1.707-3.

(4) *Special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan.* For purposes of paragraph (a)(1) of this section, if the partnership assumes or takes property or properties subject to the liabilities of more than one partner pursuant to a plan, a partner's share of the liabilities assumed or taken subject to by the partnership pursuant to that plan immediately after the transfers equals the sum of that partner's shares of the liabilities (other than that partner's qualified liabilities, as defined in paragraph (a)(6) of this section) assumed or taken subject to by the partnership pursuant to the plan. This paragraph (a)(4) does not apply to any liability assumed or taken