

affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest. Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:

Example 1. Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of \$10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has \$50,000 ordinary income. A must include \$15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends (\$10,000 guaranteed payment plus \$5,000 distributive share).

Example 2. Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than \$10,000. The income of the partnership is \$60,000, and C is entitled to \$18,000 (30 percent of \$60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of \$20,000 instead of \$60,000, \$6,000 (30 percent of \$20,000) would be partner C's distributive share, and the remaining \$4,000 payable to C would be a guaranteed payment.

Example 3. Partner X in the XY partnership is to receive a payment of \$10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of \$10,000 to partner X, the XY partnership has a loss of \$9,000. Of this amount, \$2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of \$10,000 made to him by the partnership.

Example 4. Assume the same facts as in example 3 of this paragraph, except that, instead of a \$9,000 loss, the partnership has \$30,000 in capital gains and no other items of income or deduction except the \$10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a \$10,000 ordinary loss and \$30,000 in capital gains. X's 30 percent distributive shares of these amounts are \$3,000 ordinary loss and \$9,000 capital gain. In addition, X has received a \$10,000 guaranteed payment which is ordinary income to him.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7891, 48 FR 20049, May 4, 1983]

§ 1.707-2 Disguised payments for services. [Reserved]

§ 1.707-3 Disguised sales of property to partnership; general rules.

(a) *Treatment of transfers as a sale—(1) In general.* Except as otherwise provided in this section, 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 that partner are described in paragraph (b)(1) of this section, the transfers are treated as a sale of property, in whole or in part, to the partnership.

(2) *Definition and timing of sale.* For purposes of §§ 1.707-3 through 1.707-5, the use of the term sale (or any variation of that word) to refer to a transfer of property by a partner to a partnership and a transfer of consideration by a partnership to a partner means a sale or exchange of that property, in whole or in part, to the partnership by the partner acting in a capacity other than as a member of the partnership, rather than a contribution and distribution to which sections 721 and 731, respectively, apply. A transfer that is treated as a sale under paragraph (a)(1) of this section is treated as a sale for all purposes of the Internal Revenue Code (*e.g.*, sections 453, 483, 1001, 1012, 1031 and 1274). The sale is considered to take place on the date that, under general principles of Federal tax law, the partnership is considered the owner of the property. If the transfer of money or other consideration from the partnership to the partner occurs after the transfer of property to the partnership, the partner and the partnership are treated as if, on the date of the sale,

the partnership transferred to the partner an obligation to transfer to the partner money or other consideration.

(3) *Application of disguised sale rules.* If a person purports to transfer property to a partnership in a capacity as a partner, the rules of this section apply for purposes of determining whether the property was transferred in a disguised sale, even if it is determined after the application of the rules of this section that such person is not a partner. If after the application of the rules of this section to a purported transfer of property to a partnership, it is determined that no partnership exists because the property was actually sold, or it is otherwise determined that the contributed property is not owned by the partnership for tax purposes, the transferor of the property is treated as having sold the property to the person (or persons) that acquired ownership of the property for tax purposes.

(4) *Deemed terminations under section 708.* In applying the rules of this section, transfers resulting from a termination of a partnership under section 708(b)(1)(B) are disregarded.

(b) *Transfers treated as a sale—(1) In general.* A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or the taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances—

(i) The transfer of money or other consideration would not have been made but for the transfer of property; and

(ii) In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

(2) *Facts and circumstances.* The determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale, in whole or in part, under paragraph (b)(1) of this section is made based on all the facts and circumstances in each case. The

weight to be given each of the facts and circumstances will depend on the particular case. Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists under paragraph (b)(1) of this section. Among the facts and circumstances that may tend to prove the existence of a sale under paragraph (b)(1) of this section are the following:

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the transferor has a legally enforceable right to the subsequent transfer;

(iii) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(iv) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

(vi) That a partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(viii) That partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

(c) *Transfers made within two years presumed to be a sale*—(1) *In general.* For purposes of this section, if within a two-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.

(2) *Disclosure of transfers made within two years.* Disclosure to the Internal Revenue Service in accordance with § 1.707-8 is required if—

(i) A partner transfers property to a partnership and the partnership transfers money or other consideration to the partner with a two-year period (without regard to the order of the transfers);

(ii) The partner treats the transfers other than as a sale for tax purposes; and

(iii) The transfer of money or other consideration to the partner is not presumed to be a guaranteed payment for capital under § 1.707-4(a)(1)(ii), is not a reasonable preferred return within the meaning of § 1.707-4(a)(3), and is not an operating cash flow distribution within the meaning of § 1.707-4(b)(2).

(d) *Transfers made more than two years apart presumed not to be a sale.* For purposes of this section, if a transfer of money or other consideration to a partner by a partnership and the transfer of property to the partnership by that partner are more than two years apart, the transfers are presumed not to be a sale of the property to the part-

nership unless the facts and circumstances clearly establish that the transfers constitute a sale.

(e) *Scope.* This section and §§ 1.707-4 through 1.707-9 apply to contributions and distributions of property described in section 707(a)(2)(A) and transfers described in section 707(a)(2)(B) of the Internal Revenue Code.

(f) *Examples.* The following examples illustrate the application of this section.

Example 1. Treatment of simultaneous transfers as a sale. A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in the partnership. At the time of the transfer, property X has a fair market value of \$4,000,000 and an adjusted tax basis of \$1,200,000. Immediately after the transfer, the partnership transfers \$3,000,000 in cash to A. Assume that, under this section, the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Because the amount of cash A receives on April 9, 1992, does not equal the fair market value of the property, A is considered to have sold a portion of property X with a value of \$3,000,000 to the partnership in exchange for the cash. Accordingly, A must recognize \$2,100,000 of gain (\$3,000,000 amount realized less \$900,000 adjusted tax basis (\$1,200,000 multiplied by \$3,000,000/\$4,000,000)). Assuming A receives no other transfers that are treated as consideration for the sale of the property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, \$1,000,000 of the fair market value of the property with an adjusted tax basis of \$300,000.

Example 2. Treatment of transfers at different times as a sale. (i) The facts are the same as in *Example 1*, except that the \$3,000,000 is transferred to A one year after A's transfer of property X to the partnership. Assume that under this section the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Assume also that the applicable Federal short-term rate for April, 1992, is 10 percent, compounded semiannually.

(ii) Under paragraph (a)(2) of this section, A and the partnership are treated as if, on April 9, 1992, A sold a portion of property X to the partnership in exchange for an obligation to transfer \$3,000,000 to A one year later. Section 1274 applies to this obligation because it does not bear interest and is payable more than six months after the date of the sale. As a result, A's amount realized from the receipt of the partnership's obligation will be the imputed principal amount of the partnership's obligation to transfer \$3,000,000 to A, which equals \$2,721,088 (the present value on April 9, 1992, of a \$3,000,000 payment

due one year later, determined using a discount rate of 10 percent, compounded semi-annually). Therefore, A's amount realized from the receipt of the partnership's obligation is \$2,721,088 (without regard to whether the sale is reported under the installment method). A is therefore considered to have sold only \$2,721,088 of the fair market value of property X. The remainder of the \$3,000,000 payment (\$278,912) is characterized in accordance with the provisions of section 1272. Accordingly, A must recognize \$1,904,761 of gain (\$2,721,088 amount realized less \$816,327 adjusted tax basis (\$1,200,000 multiplied by \$2,721,088/\$4,000,000)) on the sale of property X to the partnership. The gain is reportable under the installment method of section 453 if the sale is otherwise eligible. Assuming A receives no other transfers that are treated as consideration for the sale of property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, \$1,278,912 of the fair market value of property X with an adjusted tax basis of \$383,673.

Example 3. Operation of presumption for transfers within two years. (i) C transfers undeveloped land to the CD partnership in exchange for an interest in the partnership. The partnership intends to construct a building on the land. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of \$500,000 and a fair market value of \$1,000,000. The partnership agreement provides that upon completing construction of the building the partnership will distribute \$900,000 to C.

(ii) If, within two years of C's transfer of land to the partnership, a transfer is made to C pursuant to the provision requiring a distribution upon completion of the building, the transfer is presumed to be, under paragraph (c) of this section, part of a sale of the land to the partnership. C may rebut the presumption that the transfer is part of a sale if the facts and circumstances clearly establish that—

(A) The transfer to C would have been made without regard to C's transfer of land to the partnership; or

(B) The partnership's obligation or ability to make this transfer to C depends, at the time of the transfer to the partnership, on the entrepreneurial risks of partnership operations.

(iii) For example, if the partnership will be able to fund the transfer of cash to C only to the extent that permanent loan proceeds exceed the cost of constructing the building, the fact that excess permanent loan proceeds will be available only if the cost to complete the building is significantly less than the amount projected by a reasonable budget would be evidence that the transfer to C is not part of a sale. Similarly, a condition that limits the amount of the permanent

loan to the cost of constructing the building (and thereby limits the partnership's ability to make a transfer to C) unless all or a substantial portion of the building is leased would be evidence that the transfer to C is not part of a sale, if a significant risk exists that the partnership may not be able to lease the building to that extent. Another factor that may prove that the transfer of cash to C is not part of a sale would be that, at the time the land is transferred to the partnership, no lender has committed to make a permanent loan to fund the transfer of cash to C.

(iv) Facts indicating that the transfer of cash to C is not part of a sale, however, may be offset by other factors. An offsetting factor to restrictions on the permanent loan proceeds may be that the permanent loan is to be a recourse loan and certain conditions to the loan are likely to be waived by the lender because of the creditworthiness of the partners or the value of the partnership's other assets. Similarly, the factor that no lender has committed to fund the transfer of cash to C may be offset by facts establishing that the partnership is obligated to attempt to obtain such a loan and that its ability to obtain such a loan is not significantly dependent on the value that will be added by successful completion of the building, or that the partnership reasonably anticipates that it will have (and will utilize) an alternative source to fund the transfer of cash to C if the permanent loan proceeds are inadequate.

Example 4. Operation of presumption for transfers within two years. E is a partner in the equal EF partnership. The partnership owns two parcels of unimproved real property (*parcels 1 and 2*). Parcels 1 and 2 are unencumbered. Parcel 1 has a fair market value of \$500,000, and parcel 2 has a fair market value of \$1,500,000. E transfers additional unencumbered, unimproved real property (*parcel 3*) with a fair market value of \$1,000,000 to the partnership in exchange for an increased interest in partnership profits of 66% percent. Immediately after this transfer, the partnership sells parcel 1 for \$500,000 in a transaction not in the ordinary course of business. The partnership transfers the proceeds of the sale \$333,333 to E and \$166,667 to F in accordance with their respective partnership interests. The transfer of \$333,333 to E is presumed to be, in accordance with paragraph (c) of this section, a sale, in part, of parcel 3 to the partnership. However, the facts of this example clearly establish that \$250,000 of the transfer to E is not part of a sale of parcel 3 to the partnership because E would have been distributed \$250,000 from the sale of parcel 1 whether or not E had transferred parcel 3 to the partnership. The transfer to E exceeds by \$83,333 (\$333,333 minus \$250,000) the amount of the distribution that would have been made to E if E had not

transferred parcel 3 to the partnership. Therefore, \$83,333 of the transfer is presumed to be part of a sale of a portion of parcel 3 to the partnership by E.

Example 5. Operation of presumption for transfers more than two years apart. (i) G transfers undeveloped land to the GH partnership in exchange for an interest in the partnership. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of \$500,000 and a fair market value of \$1,000,000. H contributes \$1,000,000 in cash in exchange for an interest in the partnership. Under the partnership agreement, the partnership is obligated to construct a building on the land. The projected construction cost is \$5,000,000, which the partnership plans to fund with its \$1,000,000 in cash and the proceeds of a construction loan secured by the land and improvements.

(ii) Shortly before G's transfer of the land to the partnership, the partnership secures commitments from lending institutions for construction and permanent financing. To obtain the construction loan, H guarantees completion of the building for a cost of \$5,000,000. The partnership is not obligated to reimburse or indemnify H if H must make payment on the completion guarantee. The permanent loan will be funded upon completion of the building, which is expected to occur two years after G's transfer of the land. The amount of the permanent loan is to equal the lesser of \$5,000,000 or 80 percent of the appraised value of the improved property at the time the permanent loan is closed. Under the partnership agreement, the partnership is obligated to apply the proceeds of the permanent loan to retire the construction loan and to hold any excess proceeds for transfer to G 25 months after G's transfer of the land to the partnership. The appraised value of the improved property at the time the permanent loan is closed is expected to exceed \$5,000,000 only if the partnership is able to lease a substantial portion of the improvements by that time, and there is a significant risk that the partnership will not be able to achieve a satisfactory occupancy level. The partnership completes construction of the building for the projected cost of \$5,000,000 approximately two years after G's transfer of the land. Shortly thereafter, the permanent loan is funded in the amount of \$5,000,000. At the time of funding the land and building have an appraised value of \$7,000,000. The partnership transfers the \$1,000,000 excess permanent loan proceeds to G 25 months after G's transfer of the land to the partnership.

(iii) G's transfer of the land to the partnership and the partnership's transfer of \$1,000,000 to G occurred more than two years apart. In accordance with paragraph (d) of this section, those transfers are presumed not to be a sale unless the facts and cir-

cumstances clearly establish that the transfers constitute a sale of the property, in whole or part, to the partnership. The transfer of \$1,000,000 to G would not have been made but for G's transfer of the land to the partnership. In addition, at the time G transferred the land to the partnership, G had a legally enforceable right to receive a transfer from the partnership at a specified time an amount that equals the excess of the permanent loan proceeds over \$4,000,000. In this case, however, there was a significant risk that the appraised value of the property would be insufficient to support a permanent loan in excess of \$4,000,000 because of the risk that the partnership would not be able to achieve a sufficient occupancy level. Therefore, the facts of this example indicate that at the time G transferred the land to the partnership the subsequent transfer of \$1,000,000 to G depended on the entrepreneurial risks of partnership operations. Accordingly, G's transfer of the land to the partnership is not treated as part of a sale.

Example 6. Rebuttal of presumption for transfers more than two years apart. The facts are the same as in *Example 5*, except that the partnership is able to secure a commitment for a permanent loan in the amount of \$5,000,000 without regard to the appraised value of the improved property at the time the permanent loan is funded. Under these facts, at the time that G transferred the land to the partnership the subsequent transfer of \$1,000,000 to G was not dependent on the entrepreneurial risks of partnership operations, because during the period before the permanent loan is funded, the permanent lender's obligation to make a loan in the amount necessary to fund the transfer is not subject to the contingencies related to the risks of partnership operations, and after the permanent loan is funded, the partnership holds liquid assets sufficient to make the transfer. Therefore, the facts and circumstances clearly establish that G's transfer of the land to the partnership is part of a sale.

Example 7. Operation of presumption for transfers more than two years apart. The facts are the same as in *Example 6*, except that H does not guarantee either that the improvements will be completed or that the cost to the partnership of completing the improvements will not exceed \$5,000,000. Under these facts, if there is a significant risk that the improvements will not be completed, G's transfer of the land to the partnership will not be treated as part of a sale because the lender is required to make the permanent loan if the improvements are not completed. Similarly, the transfers will not be treated as a sale to the extent that there is a significant risk that the cost of constructing the improvements will exceed \$5,000,000, because, in the absence of a guarantee of the cost of

the improvements by H, the \$5,000,000 proceeds of the permanent loan might not be sufficient to retire the construction loan and fund the transfer to G. In either case, the transfer of cash to G would be dependent on the entrepreneurial risks of partnership operations.

Example 8. Rebuttal of presumption for transfers more than two years apart. (i) On February 1, 1992, I, J, and K form partnership IJK. On formation of the partnership, I transfers an unencumbered office building with a fair market value of \$50,000,000 and an adjusted tax basis of \$20,000,000 to the partnership, and J and K each transfer United States government securities with a fair market value and an adjusted tax basis of \$25,000,000 to the partnership. Substantially all of the rentable space in the office building is leased on a long-term basis. The partnership agreement provides that all items of income, gain, loss, and deduction from the office building are to be allocated 45 percent to J, 45 percent to K, and 10 percent to I. The partnership agreement also provides that all items of income, gain, loss, and deduction from the government securities are to be allocated 90 percent to I, 5 percent to J, and 5 percent to K. The partnership agreement requires that cash flow from the office building and government securities be allocated between partners in the same manner as the items of income, gain, loss, and deduction from those properties are allocated between them. The partnership agreement complies with the requirements of §1.704-1(b)(2)(ii)(b). It is not expected that the partnership will need to resort to the government securities or the cash flow therefrom to operate the office building. At the time the partnership is formed, I, J, and K contemplated that I's interest in the partnership would be liquidated sometime after January 31, 1994, in exchange for a transfer of the government securities and cash (if necessary). On March 1, 1995, the partnership transfers cash and the government securities to I in liquidation of I's interest in the partnership. The cash transferred to I represents the excess of I's share of the appreciation in the office building since the formation of the partnership over J's and K's share of the appreciation in the government securities since they are acquired by the partnership.

(ii) I's transfer of the office building to the partnership and the partnership's transfer of the government securities and cash to I occurred more than two years apart. Therefore, those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale. Absent I's transfer of the office building to the partnership, I would not have received the government securities from the partnership. The facts including the amount and nature of partnership assets) indicate that, at the time that I transferred the office build-

ing to the partnership, the timing of the transfer of the government securities to I was anticipated and was not dependent on the entrepreneurial risks of partnership operations. Moreover, the facts indicate that 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