

# The Metaphysical Dimension of Leveraged Partnership Buyouts and Disguised Sales

By Mark Melton\*



Sales of partnership interests are commonplace in today's merger and acquisition landscape, and most transactions involve borrowing money from third-party banks to finance the purchase. But these loans are not typically made to the buyer; instead, they are made to the target itself, and the proceeds of those loans are distributed to the selling partners. This leveraged buyout structure is nothing new, but the complexity of the tax treatment regularly flummoxes both lawyers and accountants alike.

If a buyer is acquiring 100 percent of the target partnership, the analysis is straightforward—the buyer has simply financed a portion of the purchase price with debt, just like any other acquisition of property where money is borrowed.<sup>1</sup> From the sellers' perspective, they have disposed of all of their interests in the partnership and now hold cash.<sup>2</sup> Gain or loss is simply a function of the total amount of proceeds received minus each seller's basis. It does not matter in such cases where the money came from. Whether it was from the buyer's bank account or from a bank loan does not change the seller's tax analysis.

But what if the seller is only selling a portion of their partnership interest? Because the seller is retaining some percentage of the business, this means that any debt taken out by the partnership is reducing the overall value of the partnership as a whole, including the equity already held and retained by the seller. In fact, that is the point of the transaction. From one perspective, the seller is merely leveraging up the partnership prior to a sale transaction to reduce the net equity value such that the buyer is purchasing a portion of the business, but at a lower valuation (*i.e.*, the asset value less the new debt encumbering those assets).

For example, assume that a partnership has assets worth \$1 million. If a buyer wanted to purchase 80 percent of this partnership, the buyer would need to write a check to the seller for \$800k. But if instead, immediately prior to the closing, a bank loans the partnership \$700k, which is then distributed to the selling partners (who own 100 percent of the business at that moment in time), the equity of the partnership is only worth \$300k because the partnership has assets of \$1 million

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and a liability of \$700k. A buyer only needs to write a check for \$240k to acquire an 80-percent interest in the now-levered-up partnership (*i.e.*, 80 percent of \$300k).

Note that this has a real economic impact on the sellers. In the base case example, the sellers walk away with \$800k in their pockets and they still own 20 percent of the business. But in the leveraged buyout structure, they walk away with \$940k in their pockets. And they continue to own 20 percent of the business. How is it that the sellers are able to monetize 94 percent of their interest in the business, while only selling 80 percent of the company? They have taken almost all of their chips off the table, while retaining an outsized portion of the future upside. Perhaps you can see now how this might be an enticing structure for a seller.

This does not mean, necessarily, that the sellers have sold 94 percent of the business. Clearly, that has not happened because the sellers still own 20 percent. If a taxpayer owns 100 percent of an asset prior to a transaction and then owns 20 percent of that asset after a transaction, common sense dictates that the taxpayer sold only 80 percent of the asset. Because how can you have sold something you still own? Any other conclusion might appear at first to defy the physical laws of the universe. But the tax code does not always follow the physical laws of the universe. It sometimes operates in another dimension. Often, however, it winds its way through a convoluted series of fictional steps to arrive at an otherwise common-sense answer.

## The Theory of Borrowed Money

Borrowing money typically does not result in taxable income.<sup>3</sup> If you go to your bank and borrow money against your house, you have free use of the cash to do with as you please. The fact that you were able to convert an asset, even one with built-in gain, into cash does not result in taxable income because you will one day have to pay that money back. So it is not really your money; it is the bank's money. At the same time, you still own your home. If we look at your personal balance sheet, you have two assets: a house and a pile of cash. The fact that you still own your house (and the benefits and burdens of that ownership) is a good indicator under general tax principles that you have not disposed of it yet, and therefore do not need to recognize any gain or loss. Your pile of cash is more related to the fact that you have a debt with the bank than the fact that you have an asset that acted as security for that debt.

This is still true even if the loan is nonrecourse to you (*i.e.*, if you default, the bank can take the house acting as collateral, but not anything else). The nonrecourse nature

of the debt is not relevant because it is possible—and perhaps even likely—that one day you will repay the loan in full and retain any appreciation or losses the house might one day generate. This is an important point. That you could choose to walk away from your house, throw the keys to the bank, and keep all the cash without any other form of repayment does not mean that you have disposed of your property in a taxable recognition event. Only upon some future date, should you actually do that, would you have a taxable recognition event.

The same is true within the context of partnerships. The tax code has set up a system that effectively uses the aggregate theory of partnerships, which just means that we're all going to pretend that you theoretically own your proportionate share of the partnership's assets and that you owe your theoretical share of the partnership's debts. And to the extent the partnership borrows money against those assets that you indirectly own and gives it to you, there is no theoretical difference between that scenario and the one where you borrowed money against your home. The fact that you do not legally owe the bank any money or that you will never be required to return the cash in the event of default is of no consequence because it is no different than borrowing against your home on a nonrecourse basis.

## Application to Leveraged Partnerships

So what happened in the prior example where the sellers got cash representing 94 percent of the value of their partnership interest, but only sold 80 percent? Let us level set to make that make sense by viewing the transaction through the lens of the aggregate theory of partnerships.

If the partnership has \$1 million of assets, and the sellers sell 80 percent, that means \$800k of the assets have been sold to the buyer. And the buyer financed that purchase with \$240k of cash from its own bank account and \$560k of cash from the bank (*i.e.*, 80 percent of the \$700k loan). The additional \$140k in cash received by the seller is really just a loan against the \$200k in assets that it retained in the deal (*see* Table 1).

TABLE 1.

	Sellers	Buyer	Total
Ownership	20%	80%	
Assets	\$200,000	\$800,000	\$1,000,000
Debt	\$140,000	\$560,000	\$700,000
Net Equity	\$60,000	\$240,000	\$300,000
Cash to Seller	\$140,000	\$800,000	\$940,000

So it would make sense if the answer turned out to be that sellers have a sale of 80 percent of their partnership interest for \$800k and a tax-free loan of \$140k. But, of course, the tax laws are not always so simple.

Though the aggregate theory of partnerships works to create a simple theory by which to analyze partnership transactions, it is not always applied uniformly in tax law. Sometimes the entity theory of partnerships creeps in to complicate things; although often times to the benefit of taxpayers.

Consider the partnership as an independent person for a moment instead of an aggregation of its partners. If outside the context of a partnership sale, the partnership borrowed \$700k against its \$1 million of assets and used that cash to buy new business assets, we would not be having this conversation. Like you borrowing money against your house, the partnership is doing the same thing. There would be no taxable income to recognize at the partnership level. So how then does the distribution of those loan proceeds to partners, instead of using them to acquire new assets, mechanically create taxable income to match the result we arrived at under the aggregate theory analysis? Sometimes it does not. Let us explore.

## Contributing to a New Joint Venture Partnership

In our example, we took a \$1 million business and turned it into a \$300k business by saddling it with \$700k in debt and then taking that borrowed cash off the table. Instead of assuming this occurred inside a partnership, assume instead it occurred in a disregarded LLC owned by a single seller. Immediately after the loan proceeds are borrowed and deposited in the seller's bank account—a time when the net equity of the business is \$300k—buyer purchases an 80-percent interest in the LLC from seller for \$240k. What happens for tax purposes?

Rev. Rul. 99-5 provides that in such a scenario, buyer is deemed to have purchased 80 percent of the assets held by the disregarded LLC and then transferred those assets to a new partnership, and seller is deemed to have contributed the remaining assets to the same partnership. But Rev. Rul. 99-5 assumes there is no debt, and does not provide guidance on how to treat encumbered assets of the LLC.

Presumably, in our example, the buyer is deemed to acquire \$800k of the assets for a combination of \$240k in cash and \$560k in debt assumption, which encumbers the assets the buyer just purchased. If so, (assuming a zero tax basis) the seller would immediately recognize gain on \$800k of the LLC's assets. Buyer would then

contribute \$800k in assets subject to a \$560k liability, and seller would contribute \$200k in assets subject to a \$140k liability. Neither buyer nor seller would recognize any additional income upon the deemed contribution to a new partnership, despite the fact that the debt encumbering the contributed assets would in both cases not be a qualified liability.

Reg. §1.707-5(a)(1) provides that the assumption of nonqualified liabilities is treated as proceeds in a disguised sale of contributed assets only to the extent such debt assumed by the partnership exceeds the partner's share of *that* liability immediately after the contribution. This may lead one to believe that both parties might need to recognize income. Seller, for example, is contributing \$200k of assets subject to a \$140k nonqualified liability. But seller's share of *that* liability after the contribution is only \$28k (*i.e.*, 20 percent of \$140k).

Reg. §1.707-5(a)(4), however, saves the day by effectively aggregating debt encumbering contributed assets by more than one partner as part of a plan. Example 7 of Reg. §1.707-5(f) makes clear that the amount treated as proceeds in a disguised sale is limited to the debt encumbering that partner's contributed assets minus that partner's share of all debts assumed by the partnership in the contribution transaction. In this case, the seller's share of the debt deemed to be assumed alongside the buyer's contribution of assets is \$112k (\$560k multiplied by 20 percent). When that amount is added to the seller's share of the \$140k debt associated with its own capital contribution (*i.e.*, \$28k), the seller has a total share in the combined assumed debt of \$140k. Accordingly, there is no disguised sale of assets to the partnership; only the deemed sale of \$800k in assets directly to the buyer immediately prior to the deemed contribution of assets by both parties under Rev. Rul. 99-5. This scenario tracks the same result we found above using the aggregate theory of partnerships.

Just for fun, let us assume an alternative treatment of the above transaction. Instead of the buyer acquiring \$800k in LLC assets subject to \$560k in debt, assume that the buyer is treated as acquiring \$240k in LLC assets, not subject to any debt. In this scenario, the seller is left with \$760k in assets, subject to the entire \$700k liability. When the parties are thereafter deemed to contribute their respective assets, the seller's contribution is subject to a non-qualified liability. Under Reg. §1.707-5(a)(1), seller will be deemed to have sold to the partnership the portion of its contributed assets equal to the assumed debt less seller's share of *that* liability immediately after the contribution. The seller's share is \$140k because \$560k of the liability shifts to the buyer at closing when the buyer becomes an 80-percent partner (*i.e.*, \$700k in debt multiplied by

80 percent). In this scenario, the seller has two sale transactions: one for \$240k to the buyer and a second sale to the partnership of \$560k. In total, the seller recognizes a gain of \$800k in assets, the same amount calculated previously.

Does it matter then if the amount of overall gain is the same? Yes. It could. A slight change to the facts illustrates the issue. If, instead of selling 80 percent of the business, the seller was only selling a minority interest, the question of whether the purchaser of assets is the buyer or the partnership becomes very relevant. If the purchaser is the buyer (assuming the buyer is unrelated to the seller), then any gain from the sale generally will be capital gain. If, however, the purchaser is instead the partnership, and seller is a majority owner of the partnership, Code Sec. 707(b)(2) will convert any capital gain on the disguised sale transaction between seller and the partnership with respect to assets other than capital assets to ordinary income because as majority owner, the seller is related to the partnership purchaser.

Fortunately, the better argument lies in treating the transaction as a sale to buyer of \$800k of assets, subject to \$560k in debt, meaning that the sale counterparty is the unrelated buyer and not the related partnership because the documents presumably would make clear that once all the dust settles, the buyer owns an interest in \$800k of the assets, not \$240k.

## Springing Partnership Leveraged Transactions

The following discussion analyzes a transaction where a partnership is created by the seller shortly before a sale transaction (*i.e.*, a “springing partnership”). Transactions with old and cold partnership targets may present other issues outside the realm of disguised sales.<sup>4</sup>

Assume that in preparation for a sale of the business, the seller converts its disregarded operating company into a tax partnership by contributing a small percentage of the business, let us say one percent, to a new S corporation. Some version of this transaction happens regularly in the market, usually at the insistence of the buyer in situations where the anti-churning rules of Reg. §1.197-2(h) would prohibit the buyer from amortizing purchased goodwill. This is of concern any time the business of the target company is older than August 1993 and the seller is rolling more than 20 percent of its equity.<sup>5</sup>

A common workaround to an anti-churning problem is to have the buyer purchase a partnership interest with a Code Sec. 754 election in place. As long as the basis in the purchased goodwill is sitting in a Code Sec. 743

layer, instead of in the common basis within the partnership, the goodwill can be amortized by the buyer, even if the anti-churning rules otherwise would have applied.<sup>6</sup> Accordingly, a buyer in this situation will insist that a partnership be created pre-closing so that the buyer may purchase a partnership interest instead of assets or an interest in a disregarded entity.

To accommodate the buyer, assume that one week prior to closing, when there is no debt, seller contributes one percent of the membership interests of the disregarded operating LLC (“Opco”) to a newly formed S corporation (“S Corp”), which is wholly owned by seller. On the closing date, in accordance with the purchase agreement, the following steps occur in the following order:

**Step 1:** A bank lends \$700k to Opco.

**Step 2:** Opco distributes the loan proceeds 99 percent to seller and 1 percent to S Corp (the “Leveraged Distribution”).

**Step 3:** Buyer purchases 80 percent of the company’s membership interests from seller for \$240k (*i.e.*, buyer does not purchase any of the membership interest from S Corp).

Your first question may be, “Why does the buyer not purchase the S Corp’s one percent interest so we can get rid of that S corporation?” The reason is simple: if the S corporation sells its interest a week after it acquired it by contribution, the IRS easily could argue that the S corporation was transitory and therefore no partnership ever existed in the first place. The transaction would be recast as if the seller held Opco as a disregarded entity, and the buyer would be treated as buying a portion of Opco’s assets under Rev. Rul. 99-5 instead of purchasing a partnership interest. Accordingly, the buyer would have no Code Sec. 743 layer and would be denied amortization deductions on its purchased goodwill. By leaving S Corp in the structure long-term, it is difficult to argue that its existence was transitory and should be disregarded. But the IRS might still attack the formation of S Corp under Code Sec. 269.

Code Sec. 269 provides that if a person acquires control of a corporation, the IRS may disallow any “allowance” that results if the principal purpose for such acquisition is the evasion or avoidance of tax.<sup>7</sup> An allowance refers to anything in the internal revenue laws that has the effect of diminishing tax liability, including an exclusion from taxation.<sup>8</sup> In this case, the formation of S Corp does not confer a benefit on the seller, but it does confer a benefit

on the buyer (*e.g.*, the ability to amortize goodwill in a Code Sec. 743 layer). Though it seems a stretch, if the principal purpose of the transaction is the avoidance or evasion of tax, then the IRS conceivably could deny the buyer's amortization deductions. The notion of evasion or avoidance in this context is broad and is not limited to cases involving criminal penalties, civil penalties, or fraud.<sup>9</sup>

Courts and certain IRS guidance have concluded that, even where a taxpayer forms or acquires a corporation with an eye toward obtaining a tax benefit, Code Sec. 269 will not apply to prevent “tak[ing] advantage of provisions that represent a deliberate granting of tax benefits.”<sup>10</sup> It is unclear whether one could argue that Congress itself granted a deliberate tax benefit regarding amortization of goodwill through Code Sec. 743 that otherwise would not be amortizable due to the anti-churning rules. But the U.S. Treasury clearly provides for such a deliberate benefit by regulation.<sup>11</sup> It seems a heavy lift for the IRS to argue Code Sec. 269 would apply in this context, given that the regulations make an explicit exception to the anti-churning rules, the person getting the deductions is not related to the taxpayer forming S Corp, and the seller is not getting any benefit from its formation of S Corp.

You should also note here that the qualified liability rules discussed above do not apply here because the seller did not contribute assets to the partnership subject to debt. In this example, there is no debt at the time of the contribution to the springing partnership. Instead, the partnership itself is borrowing money and distributing it to the owners of the partnership, *pro rata* based on their ownership as of that moment in time. If there was no Step 3 (*i.e.*, the sale of the partnership interest to the buyer), the analysis would be simple. There would be no tax due. However, Step 3 does occur the following moment in time, which changes the landscape after the buyer becomes a partner. Somewhere between Step 2 and Step 3, we go from a transaction that has no taxable income consequence to one that does. But how much, and how does it work?

## Disguised Sale Analysis

Code Sec. 707(a)(2)(B) provides, in relevant part, that transfers of property by a partner to a partnership coupled with a transfer of money by that partnership to the contributing partner are treated as a sale or exchange of such property by the partner to the partnership if the transfers, when viewed together, are properly treated as a sale or exchange. This recharacterization as a sale of a contribution of property and a related distribution of cash (or other property) is referred to generally as a “disguised sale.” Though the statutory language is somewhat vague

as to which contributions and distributions should be paired together and treated as a sale, Reg. §1.707-3(c)(1) provides that transfers of cash by a partnership within two years of the contribution of property are presumed to be part of a disguised sale transaction, unless an explicit exception applies or the presumption is rebutted with evidence that “clearly establishes” that the transfers do not constitute a sale.

Under the facts at issue here, the seller and S Corp have contributed property to Opco (or at least, they are deemed to have done so). One week later, in the same transaction that contractually obligated the seller to engage in the pre-closing reorganization that resulted in the deemed contributions, \$700k of cash is distributed to the seller and S Corp. There is no rebuttal to the presumption that the distribution of cash is related to the contribution. Clearly, it is. Accordingly, to avoid a disguised sale, we must look to an available exception to the disguised sale rule.

Certain distributions by a partnership that are funded with debt of the partnership are explicitly excluded from the disguised sale rule (*i.e.*, such distributions will not be treated as part of a disguised sale even if made within the two-year period following a contribution of property by the partner receiving the distribution).<sup>12</sup> One such qualifying distribution is referred to as a “debt-financed distribution.” To qualify as a debt-financed distribution, a distribution must be traceable to money borrowed by the partnership within the 90-day period immediately preceding such distribution, but such amounts will only be debt-financed distributions to the extent the distribution does not exceed the recipient partner's “allocable share” of the partnership debt from which the distribution is derived.<sup>13</sup>

A partner's “share” of a partnership liability is differentiated in the regulations from a partner's “allocable share” of such liability. A partner's share of a partnership liability is determined under Code Sec. 752, except that with respect to nonrecourse debt the partner's share is the amount of the debt multiplied by the percentage used to calculate excess nonrecourse liabilities in Reg. §1.752-3(a)(3) (*i.e.*, allocations of nonrecourse debt under Reg. §§1.752-3(a)(1) and (2) are disregarded for this purpose).

A partner's “allocable share” of that same liability is equal to (i) such partner's share of the liability, as discussed above, multiplied by (ii) a fraction wherein the numerator is the portion of the liability distributed to the partner and the denominator is the entire amount of such liability.<sup>14</sup> For example, if a partnership with two equal partners borrows \$100 of nonrecourse debt and distributes the entire \$100 to only one partner, only \$50 of that distribution will be treated as a debt-financed distribution for purposes of the disguised sale rules (*i.e.*, the partner's share will be \$50

as determined under Code Sec. 752 multiplied by \$100 (the amount distributed to the partner) and divided by \$100 (the total amount of the liability)). The remaining \$50 would be subject to a presumption that it is a part of a disguised sale in relation to any property contributed by the recipient partner in the preceding two years.<sup>15</sup>

Where distributions funded by debt are made to more than one partner as part of a plan, a different rule applies. Under this construct, each partner determines their allocable share by multiplying their respective share of the liability, as determined under Code Sec. 752, by a fraction wherein the numerator is the portion of the liability distributed to all partners and the denominator is the entire amount of such liability.<sup>16</sup> This rule does not apply, however, if the distributions to multiple partners are made with a principal purpose of reducing the extent to which any transfer is treated as a disguised sale.<sup>17</sup>

The application of these two different rules produces vastly different results. To illustrate this conclusion, assume the same facts in the example above, except that each partner receives a \$50 distribution out of the loan proceeds of \$100. If the rule in Reg. §1.707-5(b)(2)(i) applies, each partner will be treated as receiving only \$25 as a debt-financed distribution (*i.e.*, each partner's share will be \$50 as determined under Code Sec. 752 multiplied by \$50 (the amount distributed to *the partner*) and divided by \$100 (the total amount of the liability)). But if the rule in Reg. §1.707-5(b)(2)(ii) applies, each partner will be treated as receiving the full \$50 distribution as a debt-financed distribution (*i.e.*, the partner's share will be \$50 as determined under Code Sec. 752 multiplied by \$100 (the amount distributed to *all partners*) and divided by \$100 (the total amount of the liability)).

As long as there is no principal purpose of reducing the extent to which any transfer is treated as a disguised sale, the more favorable rule in Reg. §1.707-5(b)(2)(ii) will apply. The author is unaware of any authorities directly addressing the meaning of "principal purpose" in the context of Code Sec. 707. But the interpretation of the same phrase in other tax avoidance contexts is instructive. The Tax Court provides the following analysis:

The proper test for whether tax avoidance was a principal purpose is not whether a tax-avoidance purpose "figures prominently as a reason for the plan," or whether business reasons are "so overwhelming as to make tax avoidance a negligible concern," but, rather, whether the transaction had "as one of its 'first-in-importance' purposes the avoidance of Federal income taxes."<sup>18</sup>

The determination of a partner's share of a liability is subject to one additional anti-abuse rule, which is that a partner's share is determined after taking into account a subsequent reduction in the partner's share of a liability if:

1. At the time that the partnership incurs the liability, it is anticipated that the partner's share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer; and
2. The anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and
3. 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 partnership's distribution of the proceeds of the borrowing is treated as part of a sale.<sup>19</sup>

The effect of this rule, where it applies, is to calculate a partner's "allocable share" of a partnership liability by reference not to the partner's "share" of the liability as determined under Code Sec. 752 as of the date of the distribution, but rather by reference to some lower amount determined after anticipated future events occur. This would reduce the amount of a distribution treated as a debt-financed distribution and increase the remaining portion of a distribution that might be treated as part of a disguised sale.

Reg. §1.707-5(f) (Ex. 3)<sup>20</sup> provides an illustration of the application of this anticipated reduction rule. In the example, the partner receiving the distribution has guaranteed the underlying debt, which under Code Sec. 752 would result in the guaranteed portion of the debt being treated as recourse debt that is allocable to the guaranteeing partner. This also means that the guaranteed portion of the debt generally is treated as the guaranteeing partner's "share" of the liability for purposes of the disguised sale rules. But according to the example, the guarantee falls off after three years with no conditions other than the mere passage of time. Such a change would presumably convert the liability to nonrecourse debt under Code Sec. 752, which would reduce the amount treated as the partner's share. The example implies that the stated purpose of the guarantee was to allocate losses to the guaranteeing partner, but that such losses were not actually anticipated to occur. Accordingly, the example concludes that the principal purpose must be to reduce the portion treated as a disguised sale, and therefore the partner must calculate its share of the liability based on the lower amount that would result after the guarantee was not in place.

## Application of the Disguised Sale Rules to the Leveraged Partnership Example

The heart of the question at issue is whether an anticipated sale of partnership interests, which consequently reduces the selling partner's share of partnership liabilities, will trigger the anticipated reduction rule in Reg. §1.707-5(b)(2)(iii). Said another way, should a partner that receives a distribution of debt proceeds prior to a sale of partnership interests calculate the amount of its debt-financed distribution using its "share" of partnership liabilities as of the moment in time when the distribution is made or should it instead use its "share" of partnership liabilities immediately after the sale of a portion of its partnership interests under the anticipated reduction rule?

The Leveraged Distribution is made immediately prior to the seller's sale of 80 percent of its partnership interest in Opco. At the time of the Leveraged Distribution, the seller owns 99 percent of Opco and S Corp owns one percent. The distributions follow this *pro rata* ownership. Because multiple partners (*i.e.*, both seller and S Corp) are receiving distributions derived from the debt, the rule in Reg. §1.707-5(b)(2)(ii) should apply, absent an improper principal purpose. Accordingly, the entire amount of the distribution should be treated as a debt-financed distribution, leaving no amount of the distribution available for a presumed disguised sale.

At the time the Leveraged Distribution is made, each of the seller and S Corp is a *pro rata* partner, and each partner's "share" of the liability would be determined under Reg. §1.752-3(a)(3).<sup>21</sup> Accordingly, the seller's share would be 99 percent of the liability and S Corp's share would be one percent. Because 100 percent of the proceeds of the liability are distributed to the partners, the amount allowable to each partner as a debt-financed distribution would be equal to their respective share of the liability (*i.e.*, the entire amount of the distribution received).<sup>22</sup>

There are two theories under which this conclusion might be attacked. First, if the distributions of debt proceeds are part of a plan with a principal purpose of avoiding the disguised sale rules, the IRS could assert that the "allocable share" rules of Reg. §1.707-5(b)(2)(i) apply instead of those in Reg. §1.707-5(b)(2)(ii).<sup>23</sup> Even if applicable, this would only result in minimal distortions given the 99/1 percent ownership.<sup>24</sup>

Second, the anticipated reduction rule could be argued as a way to reduce the amount of distributions received by the seller that would be treated as debt-financed distributions. Note that the anticipated reduction rule would not impact S Corp, as S Corp is not selling any portion of its

interest in Opco and should retain its one percent share of the debt going forward. But the seller's allocation of debt would drop from 99 percent to 19 percent immediately after the sale of the partnership interest to the buyer.

In order for the anticipated reduction rule to apply to the seller, the three elements enumerated in the discussion above must all be true as the test is conjunctive. First, is it anticipated that the seller's share of the liability will be reduced subsequent to the distribution? The answer to this question is almost certainly yes. The reallocation of debt from seller to buyer will occur mere moments in time after the distribution is made to the seller. This conclusion, however, is not fatal because the other two elements of the anticipated reduction rule must also be true.

Second, is the anticipated reduction not subject to the entrepreneurial risks of partnership operations? Presumably, the entrepreneurial risk element is intended instead to allow taxpayers to ignore debt repayment through ordinary course operations of the partnership, which certainly are otherwise anticipated reductions in partnership debt. The real question here is whether the debt reduction is expected to come from payments derived from partnership operations or from some other source. Accordingly, this element of the anticipated reduction rule likely also is satisfied, but once again is not by itself fatal.

Finally, is the reduction of the seller's share of the partnership's debt part of a plan that has as one of its principal purposes minimizing the extent to which the Leveraged Distribution is treated as part of a sale? The answer to this question may be no. And if that is true, then at least one of the elements of the anticipated reduction rule is not satisfied and the seller would calculate its share of partnership debt at the moment in time the distribution is made, as opposed to some future time when its share of partnership debt is lower, even if that future time is mere moments later.

Before analyzing the meaning of a principal purpose, it is important to ask a very relevant question. A principal purpose to do what, exactly? In this case, it is to minimize the extent to which the partnership's distribution of the borrowed cash is treated "as part of a sale."<sup>25</sup> Reg. §1.707-5(b)(2)(iii)(C) does not say "as part of a *disguised* sale." Contrast that with the similar anti-abuse rule in Reg. §1.707-5(b)(2)(ii)(B), which deals with whether distributions to multiple partners as part of a plan can be aggregated to determine a partner's allocable share of a liability. That rule uses different language, and looks at the extent to which a transfer "is taken into account under paragraph (b)(1) ..." Reg. §1.707-5(b)(1) is the provision that determines how much of a distribution of debt proceeds is treated as a disguised sale, which indicates the

drafters of the regulation knew how to limit their meaning only to a disguised sale when that was their intent. Does this difference in language within these two provisions, which are mere sentences apart, mean that “as part of a sale” should be interpreted as something different, or perhaps broader, than just a disguised sale?

The surplusage canon may be instructive here. It provides that, if possible, every word and every provision is to be given effect, none should be ignored, and none should needlessly be given an interpretation that causes it to duplicate another provision or to have no consequence.<sup>27</sup> Said another way, an interpretation of a legal text should “lean in favor of a construction which will render every word operative, rather than one which may make some idle and nugatory.”<sup>28</sup> That the drafters of Reg. §1.707-5 used the phrase “as part of a sale” in one provision and instead pointed to a disguised sale in the immediately preceding provision, with each provision discussing impermissible principal purposes, should indicate that different meanings were, in fact, intended because different words should be read to mean different things.

Our analysis of this provision could be viewed through the lens of the criminal law construct of *mens rea* and *actus reus*. The *actus reus* is the minimization of the extent to which the distribution is treated as part of a sale, and the *mens rea* is that this result is one of the principal purposes of the future reduction of the partner’s share of the liability giving rise to the distribution. We can isolate the *actus reus* element by removing the *mens rea* element from the provision. If the resulting statement is not true, then the principal purpose element is irrelevant because there can be no principal purpose to achieve an end that is never actually achieved. Such a provision would read as follows:

The reduction of the partner’s share of the liability is part of a plan that minimizes the extent to which the partnership’s distribution of the proceeds of the borrowing is treated as part of a sale.

So is the reduction of sellers’ share of the liability part of a plan to minimize the extent to which the distribution is treated as part of a sale? It appears the answer is no. And if that is true, then there is no *actus reus* element against which the *mens rea* element could apply. Accordingly, the anti-abuse provision would not apply because there is no purpose at all to minimize the portion of the distribution treated as a sale, much less a principal purpose to do so.

Though the Leveraged Distribution does not directly result in a sale, under the facts of our example it is still part of a plan to sell partnership interests. And it is the sale of such partnership interests as part of that plan that

results in a reduction of the sellers’ share of partnership liabilities. To the extent there is a reduction in the sellers’ share of partnership liabilities as a result of the sale (because such liabilities are shifted to the buyer), such amounts *are* treated as sales proceeds “as part of a sale” of the partnership interests.<sup>29</sup> Granted, this transaction does not result in a “disguised sale,” but Reg. §1.707-5(b)(2)(iii)(C) does not appear to require such a narrow reading when there is an actual “sale” transaction effected as part of the plan that gave rise to the reduction of the sellers’ share of partnership liabilities.

Even if, for argument’s sake, we assume that the *actus reus* element is satisfied, there still must be an impermissible principal purpose. Similar to the *actus reus* elements of Reg. §§1.707-5(b)(2)(ii)(B) and 1.707-5(b)(2)(iii)(C), the *mens rea* elements also are different. Reg. §1.707-5(b)(2)(iii)(C) provides that the plan has as “one of its principal purposes,” while Reg. §1.707-5(b)(2)(ii)(B) provides that a transfer is made with “a principal purpose.” Does the phrase “a principal purpose” mean that it could be a principal purpose among other principal purposes or does it mean that it must be *the* principal purpose? The surplusage canon would suggest the latter given that Reg. §1.707-5(b)(2)(iii)(C) uses precise language when the regulation intends that a principal purpose could be one of several. Perhaps, because Reg. §1.707-5(b)(2)(ii)(B) uses different language, it should be inferred that a different meaning is intended.

This reading of the *mens rea* elements of each provision implies that the anti-abuse provision in Reg. §1.707-5(b)(2)(iii)(C) should perhaps be read more broadly than the one in Reg. §1.707-5(b)(2)(ii)(B). Regardless, even taking the broader of the two provisions into account, solid arguments exist to conclude there is no impermissible principal purpose in our example under either standard.

Looking to the Tax Court’s analysis in *Pitcher*, a “principal purpose” is one that is a “first-in-importance” purpose to avoid tax.<sup>30</sup> It is also important to note here that the Tax Court was reviewing a provision that looked to whether a transaction had “as one of its principal purposes” a tax avoidance motivation, as opposed to the arguably higher standard of the transaction having *the* principal purpose of tax avoidance or evasion. The only reason any of these transactions are occurring is to transfer 80 percent of the economics of Opco’s business to the buyer, an unrelated third party, in a transaction negotiated at arm’s length. The tax results of the larger transaction are not a first-in-importance purpose for engaging in the transaction. The first-in-importance purpose is for the sellers to take a material amount of money off the table and for the buyer to acquire a stake in the business. Even to the extent the IRS

could argue that the debt distribution feature of the larger sale transaction “figures prominently as a reason for the plan,” such a conclusion still would not rise to the level of a principal purpose under the Tax Court’s reasoning as the purpose of the debt distribution is to put cash permanently into the pocket of the seller, not to achieve a particular tax outcome.<sup>31</sup> This same reasoning is applicable with respect to S Corp being included in the distribution of debt proceeds alongside seller (*i.e.*, to evaluate whether there was a principal purpose to avoid the disguised sale rules), as even if that step is viewed standing alone, the purpose of S Corp receiving a distribution was to maintain the *pro rata* economic relationship of the partners, not to force the use of the more beneficial rule in Reg. §1.707-5(b)(2)(ii)(A), a result that has only nominal effect in any case.

*It is an unfortunate absurdity that these structures, each of which ends in an identical economic arrangement among the partners, might have differing tax consequences.*

Even to the extent the IRS successfully argued that the principal purpose analysis applies solely to discreet steps within the larger sale transaction—each standing alone, as opposed to the larger sale transaction itself—it would be difficult to argue that a primary purpose of any singular step in the instant transaction has a primary purpose of avoiding a disguised sale. Unlike the example cited above from the regulations, where the reduction in the partner’s share of liability was caused by the anticipated expiration of a personal guarantee, the function of which served solely to avoid a disguised sale as a practical matter, the transaction giving rise to an anticipated change in the partners’ shares of Opco’s partnership liability has real economic consequences. The primary purpose of the buyer’s acquisition of Opco membership interests is not to avoid a disguised sale; rather, it is to engage as a party in a very real sale of partnership interests. The reduction of the seller’s share of the partnership liability is merely ancillary to that sale.

Further, simply because the Leveraged Distribution fails to result in taxable gain on a disguised sale, if respected as a debt-financed distribution, that does not mean the seller is not recognizing any taxable income on account

of distributed debt proceeds. The shifting of debt from seller to buyer still has a tax effect because that amount is treated as sales proceeds in respect of the sale of the partnership interest.<sup>32</sup>

Assuming the form of the transaction is respected, let us analyze the results. Seller is selling an 80 percent interest in Opco to the buyer. Under the reasoning described above, none of the Leveraged Distribution is treated as a disguised sale from the seller to Opco. The proceeds of the sale from seller to buyer will be equal to the cash received by the seller plus the amount of partnership liabilities that shift from seller to buyer.<sup>33</sup> Accordingly, the seller is treated as receiving proceeds of \$800k (\$240k in cash from the buyer and deemed proceeds of \$560k relating to debt shifting away from the seller to the buyer). Once again, the seller has recognized the correct amount of sales proceeds, which is the same amount determined above using just the aggregate theory of partnerships.

Some tax professionals get hung up on the idea that the debt shifting from seller to buyer might cause distributions in excess of basis or other anomalies, which normally would be true outside the context of a sale of partnership interests. But that is not correct. The debt shifting that occurs as a result of the sale of a partnership interest is instead treated as proceeds of the sale, not as a distribution to the partner being relieved of the liability.<sup>34</sup>

## Basis Issues

In all scenarios above, the total sales proceeds equaled \$800k, or 80 percent of fair market value of the assets. But are there any basis issues that might occur in these various structures that have the effect of changing the amount of gain the seller will recognize? It seems not.<sup>35</sup>

To test this conclusion, let us review two scenarios. In the first, assume the seller’s inside and outside basis is \$750k immediately after the partnership is formed. In the second, assume the basis is only \$300k. Specifically, what we are testing for here is whether it makes any difference whether the asset basis is greater or lesser than the total amount of the Leveraged Distribution.

In the first scenario, immediately after the partnership is formed, sellers have a basis in the partnership interests of \$750k. After the partnership borrows \$700k, sellers’ bases in their partnership interests are increased under Code Sec. 752 to \$1.45 million. But when the \$700k of borrowed cash is distributed, the partners’ bases drop back down to \$750k, which amount is now comprised of \$50k in basis derived from their collective contributions from carryover basis (\$750k of carryover basis minus \$700k of

cash distributions) and \$700k in basis derived from their allocation of debt under Code Sec. 752.

Rev. Rul. 84-53, Situation 1, provides that where a partner's overall outside tax basis exceeds its allocation of debt (*i.e.*, the tax basis derived from debt is less than the partner's overall basis in the partnership interest), the partner's basis in the portion of their partnership interest that is sold is equal to (1) their outside tax basis (excluding any basis derived from a debt allocation) times the portion (expressed as a percentage) of the partnership interest sold based on the relative fair market value of the portion transferred as compared to the portion retained, plus (2) the partner's share of liabilities deemed to be discharged in the sale transaction. In this example, the non-debt basis is \$50k, and 80 percent of that basis is \$40k. The portion of the partnership's debt that is deemed to be discharged is the amount of debt that shifts from the seller to the buyer, which is \$560k ( $\$700k \times 80$  percent). Accordingly, the total basis taken against the sale proceeds of \$800k is \$600k, leaving the sellers with a gain of \$200k. Note that if the seller simply sold an 80-percent undivided interest in the assets, its basis would be \$600k ( $\$750k \times 80$  percent). So the gain is identical to what it would have been in an asset sale, absent all of the machinations of subchapter K. See Table 2 below for calculations.

In the second scenario, the calculations are slightly different. But they still result in a gain amount equal to a straight asset sale.

In this example, the partners' outside bases are only \$300k, less than the amount of cash they will receive in the Leveraged Distribution. Generally, the distribution of the \$700k would cause the partners' bases to go negative

and generate gain but for the fact that the debt increases the aggregate outside basis to support a tax-deferred distribution. Under these facts, the only outside basis available is derived from the debt allocation, which leaves the partner with a total outside basis of \$300k (\$300k in rollover basis plus \$700k in allocated debt minus \$700k in distributed cash).

When the partner's share of partnership liabilities exceeds the partner's total outside basis, the partner takes basis in the sale transaction equal to its total outside tax basis (*including* any basis derived from a debt allocation) times the portion (expressed as a percentage) of the partnership interest sold based on the relative fair market value of the portion transferred as compared to the portion retained.<sup>36</sup> The result in this fact pattern is that the partner takes a basis equal to \$240k ( $\$300k \times 80$  percent). See Table 3 below for calculations.

### Timing of Transaction Steps

The discussion above assumes that the IRS will respect the timing of the steps—that the debt is borrowed and distributed prior to the buyer purchasing the now diminished partnership interest. But in reality, these steps are actually occurring simultaneously. Typically, the debt is coming into the partnership because the buyer arranged it. But for the buyer becoming a partner, there would be no acquisition debt at all. So how is it then that taxpayers get comfortable with the fiction that the debt is borrowed and distributed first, and the partnership is only sold after those events have occurred mere milliseconds earlier? And only because the purchase agreement includes

**TABLE 2.**

Pre-Distribution Outside Basis	\$750,000
Loan Distributions	\$700,000
Post-Distribution Outside Basis (excluding debt)	\$50,000
Post-Distribution Outside Basis (including debt)	\$750,000
80% of Basis (excluding debt basis)	\$40,000
Debt Deemed Discharged (80%)	\$560,000
Total Basis on Sale	\$600,000
Check Figure (Rollover Basis $\times$ 80%)	\$600,000
Cash Purchase Price	\$240,000
Debt Deemed Discharged (80%)	\$560,000
Total Proceeds on Sale	\$800,000
Net Gain on Sale	\$200,000

**TABLE 3.**

Pre-Distribution Outside Basis	\$300,000
Loan Distributions	\$700,000
Post-Distribution Outside Basis (excluding debt)	\$(400,000)
Post-Distribution Outside Basis (including debt)	\$300,000
80% of Basis (excluding debt basis)	\$-
Allocated Total Outside Basis (80%)	\$240,000
Total Basis on Sale	\$240,000
Check Figure (Rollover Basis $\times$ 80%)	\$240,000
Cash Purchase Price	\$240,000
Debt Deemed Discharged (80%)	\$560,000
Total Proceeds on Sale	\$800,000
Net Gain on Sale	\$560,000

a self-serving statement regarding the order in which the events are deemed to occur?<sup>37</sup>

This is a big question that could fill an article of its own. And the author does not address it here. Instead, this article evaluates the impact in the event the IRS were to successfully argue that the steps should be reordered and the partnership interest was purchased first, followed by a distribution of the debt proceeds.

*Until further guidance is provided, Tax advisors will need to assess each structure in light of the surrounding circumstances to evaluate whether one structure poses more risk than another.*

This scenario is harder to make sense of because the partnership purchase price of \$240k is not anywhere near the value of the partnership at the moment in time the purchase is deemed to be made (*i.e.*, before the debt is borrowed). Who would sell assets worth \$800k for only \$240k? It only makes sense with the knowledge of the next step, which is that the partnership will immediately thereafter be levered up with \$700k of debt, which we know for certain will happen, and that the money will end up one way or another in the bank account of the seller. There are two ways this could happen that would make some sense.

## The Minute Note Structure

In the minute note structure, the buyer purchases 80 percent of the partnership for its fair market value of \$800k. The purchase consideration is \$240k in cash and a note from the buyer to the sellers for the remaining \$560k. If we stop here, everything makes perfect sense. The buyer has paid the full value for the share of the partnership it has acquired. But the seller did not do this deal to get only \$240k in cash coupled with a hope and a dream that the buyer will actually pay off the note. The seller wants that cash on the closing date.

To accommodate the transaction goals, immediately after this purchase of 80 percent of the partnership interests, the partnership is deemed in a subsequent step to then borrow \$700k from the bank, followed by a distribution of that cash to its members *pro rata*, including the buyer.

As the 20-percent partner, seller gets \$140k, and as the 80-percent partner, buyer gets \$560k. The buyer then uses its share of the distributed debt to repay the minute note to the seller.

The distribution under this construct should be treated as a debt-financed distribution to multiple partners under Reg. §1.707-5(b)(2)(ii)(A), meaning that each buyer and seller should not suffer immediate taxable income on the distribution. But the anti-abuse rule turns off this favorable treatment if the transfer is “made with a principal purpose of reducing the extent to which any transfer” is treated as a disguised sale.<sup>38</sup> Accordingly, a “principal purpose” analysis should be undertaken.

From the author’s perspective, the principal purpose is not to reduce a disguised sale; rather, it is to engage in a very real sale of the partnership interest, which, as demonstrated above, results in the full taxation of gain to the seller. However, if the IRS successfully asserted this anti-abuse rule, then the general rule in Reg. §1.707-5(b)(2)(i) could possibly apply to the distribution to sellers, which could result in two possible outcomes. First, the \$140k distribution to the sellers would be treated as a debt-financed distribution of \$28k ( $\$140k \times 20$  percent) and a disguised sale of \$112k. Even worse, if the IRS disregarded the portion of the distribution made to the buyer and treated the entire \$700k as a distribution to sellers using the step-transaction doctrine to ignore the intervening step of buyer receiving the distribution and then paying that amount over to seller, \$560k would be treated as a disguised sale and \$140k would be treated as a debt-financed distribution.

Note that the first alternative would increase sellers’ overall sales proceeds by \$112k because sellers would be deemed to have sold \$800k of the partnership to the buyer and another \$112k in assets directly to the partnership in a disguised sale. This result does not follow the economic arrangement of the parties, and therefore, in the author’s view, would be difficult for the IRS to argue successfully. The second alternative, however, would leave sellers with the same amount of gain overall (*i.e.*, only \$800k in total). The only difference is that the seller would be deemed to have sold \$560k in assets to the partnership in a disguised sale and \$240k of a partnership interest to the buyer. The negative outcome here would not necessarily be to the sellers, but instead would be to the buyer. The basis increase in those \$560k of assets would now be sitting in the common basis of the partnership instead of in a Code Sec. 743 layer attributable to the buyer. If the anti-churning rules applied to the transaction, this would mean the buyer would lose the benefit of the associated depreciation and amortization of those assets.

Practitioners may get comfortable with this risk because of the absurdity of the outcome. On the whole, the transaction is intended to transfer the economics of the business to the buyer, not to create tax benefits within the partnership that could otherwise be used by sellers. Given that the only substantive difference in outcome is that the buyer would lose the benefit of tax deductions that create no abuse (*i.e.*, because a buyer should normally be able to depreciate or amortize its basis in acquired assets), it seems difficult to conclude the IRS would succeed in an effort to use an anti-abuse regulation in this way.<sup>39</sup>

## The Part Disguised Sale/ Part Contribution

Another theory the IRS might use to attack a transaction where the debt is distributed after the buyer purchases the partnership interest is to assert that the sellers only contributed \$300k in assets at the time the partnership interest was purchased. This would make sense only because when the buyer purchased an 80 percent interest for \$240k, the numbers would tie (*i.e.*, \$240k is 80 percent of \$300k). In the immediate next step, the IRS might assert that the sellers contributed the remaining \$700k in assets in exchange for a cash payment of \$700k, financed by the distribution of the borrowed funds. This transaction would result in a disguised sale of \$560k and an additional contribution of \$140k.<sup>40</sup>

Though logical, this transaction has the same effect as the second alternative recasting of the minute note structure. It merely changes the purchaser of \$560k in

assets from the buyer to the partnership itself, creating a common basis that might not be amortizable to the buyer if the anti-churning rules apply. However, this recasting of the transaction seems to be a long shot for the government, as it would require the addition of a step that never occurred (*i.e.*, a second contribution of assets of \$700k on the closing date). The step-transaction doctrine allows the government to ignore or reorder a step. It does not allow them to invent a new fictional step required for their theory to logically play out.<sup>41</sup> The fact that this scenario would be difficult for the IRS to prove up may also provide support for the conclusion that the second alternative recharacterization in the minute note structure, which is effectively the same outcome for tax purposes, also should be assigned a remote degree of risk. Using an anti-abuse rule to arrive at a conclusion exactly the same as a theory that cannot be achieved directly, even with the use of the step-transaction doctrine, could be viewed as evidence of an inappropriate use of such an anti-abuse rule.

## Summary of Conclusions

It is an unfortunate absurdity that these structures, each of which ends in an identical economic arrangement among the partners, might have differing tax consequences. And no matter how you slice it, each of the various transaction structures includes some degree of risk that it could be recast in an unfavorable way by the IRS. Until further guidance is provided, Tax advisors will need to assess each structure in light of the surrounding circumstances to evaluate whether one structure poses more risk than another.

### ENDNOTES

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<sup>1</sup> See Rev. Rul. 99-6, IRB 1999-6, 6. A purchase of 100 percent of a partnership's equity will be treated by the buyer as a purchase of the assets when the entity is a disregarded entity immediately after the acquisition.

<sup>2</sup> See *Id.* From the sellers' perspective, the transaction is treated as a sale of partnership interests.

<sup>3</sup> *Woodsam Assocs.*, CA-2, 198 F2d 357 (1952).

<sup>4</sup> See, Sloan, Sher, Sullivan & Trossen, *Order in the Court: Why Ordering Matters in Partnership Transactions*, 116 TAX NOTES 765 (Aug. 27, 2007).

<sup>5</sup> Note that the relevant percentage is actually with respect to seller's percentage interest in the combined entity. If the acquirer already has other assets, a 25-percent rolled interest in the target might only equate to some lower percentage interest in the combined partnership. As long as the seller will not own more than 20

percent of the combined entity post-closing, the anti-churning rules should not apply.

<sup>6</sup> Reg. §1.197-2(h)(12)(v)(A).

<sup>7</sup> Code Sec. 269(a).

<sup>8</sup> Reg. §1.269-1(a).

<sup>9</sup> Reg. §1.269-1(b).

<sup>10</sup> CCA 202501008 (Jan. 3, 2025), quoting *Rocco, Inc.*, 72 TC 140, 152, Dec. 36,020 (1979) (holding that Code Sec. 269 did not apply to disallow deferral of tax resulting from adoption of the cash method of accounting, in part because the tax benefits of the cash method were "consciously granted" by Congress).

<sup>11</sup> Reg. §1.197-2(h)(12)(v).

<sup>12</sup> Reg. §1.707-5(b).

<sup>13</sup> Reg. §1.707-5(b)(1).

<sup>14</sup> Reg. §1.707-5(b)(2)(i).

<sup>15</sup> If we assume that only \$50 of the liability is used to make a distribution to the partner in this example, only \$25 of such distribution would

be treated as a debt-financed distribution for purposes of the disguised sale rules (*i.e.*, the partner's share of the liability will be \$50 as determined under Code Sec. 752 multiplied by \$50 (the amount distributed to the partner) and divided by \$100 (the total amount of the liability)).

<sup>16</sup> Reg. §1.707-5(b)(2)(ii)(A).

<sup>17</sup> Reg. §1.707-5(b)(2)(ii)(B).

<sup>18</sup> *R.G. Pitcher*, 84 TC 85, Dec. 41,844 (1985), quoting *Dittler Bros., Inc.*, 72 TC 896, 913, Dec. 36,266 (1979), *aff'd. without published opinion* CA-5, 642 F2d 1211 (1981).

<sup>19</sup> Reg. §1.707-5(b)(2)(iii)(C).

<sup>20</sup> This example actually references the anticipated reduction rule found in Reg. §1.707-5(a)(3), which addresses assumptions of debt by a partnership from a partner. This rule is intended to cover the calculation of nonqualified debt assumed that would result in a disguised sale, as opposed to

debt-financed distributions. The rule, however, is nearly identical to the anticipated reduction rule in Reg. §1.707-5(b)(2)(iii), and the logic applied should apply equally by analogy.

<sup>21</sup> Reg. §1.707-5(a)(2)(ii).

<sup>22</sup> See Reg. §1.707-5(b)(2)(ii)(A) (each partner's share multiplied by 100 percent divided by 100 percent).

<sup>23</sup> See Reg. §1.707-5(b)(2)(ii)(B).

<sup>24</sup> In this scenario, seller would still be treated as having a share of the debt equal to 99 percent, leaving nearly all of its distribution treated as a debt-financed distribution (99 percent share × 99 percent/100 percent). Conversely, the S Corp would be treated as receiving almost none of its distribution as a debt-financed distribution (one percent share × one percent/100 percent). The real dollar amount, however, that is allocable to the S Corp is negligible.

<sup>25</sup> Reg. §1.707-5(b)(2)(iii)(C).

<sup>26</sup> Reg. §1.707-5(b)(2)(ii)(B).

<sup>27</sup> Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 174 (2012). See also p. 51, which clarifies that the surplusage canon applies to regulations.

<sup>28</sup> Thomas M. Cooley, *A Treatise on the Constitutional Limitations Which Rest upon the Legislative Power of the States of the American Union* 58 (1868).

<sup>29</sup> Reg. §§1.1001-2 and 1.752-1(h).

<sup>30</sup> See *infra*, footnote 19.

<sup>31</sup> *Id.*

<sup>32</sup> Reg. §§1.1001-2 and 1.752-1(h).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> But see, Sloan, Sher, Sullivan & Trossen, *Order in the Court: Why Ordering Matters in Partnership Transactions*, 116 TAX NOTES 765 (Aug. 27, 2007) for a discussion on basis issues that can occur in similar situations where the disguised sale rules may not be applicable (e.g., old and cold partnerships where no contributions have been made within two years).

<sup>36</sup> Rev. Rul. 84-53, 1984-1 CB 159, Situation 1.

<sup>37</sup> In some cases, the parties use a structure wherein the buyer forms a merger subsidiary under its acquisition vehicle. Bank financing is arranged with that merger subsidiary. The transaction steps operate such that when the bank funds the loan on the closing date, the merger subsidiary (with the borrowed cash) is merged into the target and the proceeds are then distributed. Only after that step does the buyer purchase the partnership interests in the target. The intent to cause the actual legal movements to assume the intended order of events, as opposed to merely drafting into the purchase agreement the deemed order of

events. Presumably, this may bolster the argument that the intended order of events should be respected.

<sup>38</sup> Reg. §1.707-5(b)(2)(ii)(B).

<sup>39</sup> The anti-churning rules are intended to stop a taxpayer from creating amortizable basis in a related-party transaction that would flow back to the original owner (i.e., here the seller). Because trapping the basis step up in a 743 layer attributable only to buyer, there is no risk of the perceived abuse (i.e., there is no chance of sellers getting an allocation of the depreciation and amortization and therefore no abuse to curb).

<sup>40</sup> See Reg. §1.707-5(b)(2)(i).

<sup>41</sup> *Turner Broadcasting Systems, Inc.*, 111 TC 315, 327, Dec. 52,997 (1998) ("In order to recharacterize the transaction, respondent must have a logically plausible alternative explanation that accounts for ALL the results of the transaction. The explanation may combine steps, but if it invents new ones, Courts have refused to apply the step-transaction doctrine in this manner. Useful as the step transaction doctrine may be it cannot generate events which never took place just so an additional tax liability might be asserted." (internal citations omitted)).

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