The Leveraged Partnership—Have Your Cake And Eat It Too

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This is another in a continuing series of articles written by members of the ABA Tax Section in which a member of the section teams up with a member from the section's Young Lawyers Forum.

THE OWNER OF AN APPRECIATED BUSINESS or investment asset is presented with an interesting dilemma when deciding whether to dispose of that asset. She is fortunate to own an asset worth more than its original cost; however, the Owner typically only obtains liquidity from that "locked in" gain by selling the asset, which triggers a tax liability. Therefore, the Owner may want to consider alternative options to obtain the benefit of the gain while deferring the tax. One option the Owner might consider is to enter into a section 1031 exchange. (All section references are to the Internal Revenue Code of 1986, as amended, ("Code") and all Treasury Regulations promulgated thereunder.) In a section 1031 exchange, however, the Owner will receive another piece of property, rather than cash. Therefore, the Owner has achieved only one of her desired goals, tax deferral.

A second option the Owner may consider is a leveraged partnership transaction. In a leveraged partnership transaction, the Owner contributes the asset to a newly formed partnership. The partnership then borrows money, while the Owner guarantees the partnership debt. The partnership then distributes the money to the Owner. If structured properly, the distribution to the Owner is tax free.

Although a leveraged partnership transaction can provide for a benefit as discussed in this article, the leveraged partnership transaction is not without risk and may be challenged by the IRS. Therefore, a taxpayer should obtain proper guidance before attempting such a transaction and should be aware that there is a likelihood, possibly a strong likelihood, of a challenge by the IRS.

EXAMPLE • To illustrate the above, assume Angie owns an asset with a fair market value of $2,000 and a basis of $100. If Angie sells the asset for its fair market value she will recognize a gain in the amount of $1,900, albeit most probably capital gain. However, if Angie contributes the property to a partnership, or limited liability company ("LLC") treated as a partnership for tax purposes, and enters into a leveraged partnership transaction, Angie may be able to access the $1,900 gain, without triggering gain recognition. Angie can use the cash attributable to the gain for other expenses, or business ventures, while deferring the tax on the gain. When considering these numbers in the millions, the gain would likely be substantial, as would the resulting tax liability.

In addition, a leveraged partnership transaction may permit an S corporation with "built in" gain under section 1374 to dispose of the assets before the expiration of the 10-year recognition period without recognizing the built-in gain. This is because a leveraged partnership transaction does not involve a sale of assets. This was one of the reasons the parties in the Newsday transaction in 2008 structured the transaction as a leveraged partnership.

Newsday Transaction

In the Newsday transaction, the Tribune Company ("Tribune") and Cablevision Systems Corporation ("Cablevision") entered into a partnership where Tribune contributed assets related to the Newsday newspaper business. The assets contributed by Tribune were section 1374 assets and therefore Tribune would have recognized the built-in gain if the assets were sold. The partnership then borrowed money and distributed the money to Tribune. The debt was guaranteed by Cablevision, but Tribune agreed to indemnify Cablevision, intending that the ultimate risk would lie with Tribune, giving it a basis increase.

The Newsday transaction received a great deal of press and some criticism indicating that it will be challenged by the IRS. *See* Robert Willens, *Newsday Post Mortem*, 120 Tax Notes 1211 (Sept. 22, 2008).

Ultimate Benefits

Generally, if structured properly, a leveraged partnership may, under the right circumstances, provide the Owner with a deferral of the tax liability on the gain, while simultaneously providing potential liquidity from the asset. Thus, in a leveraged partnership transaction, if structured correctly, a taxpayer can possibly have her cake and eat it too. The following articles provide additional information on leveraged partnerships: Louis S. Freeman, Dean S. Shulman, Victor Hollender, *The Partnership Union: Opportunities for Joint Ventures and Divestitures*, Prac. Law Inst. (863 PLI/Tax 9) (2009) and Michael J. Kliegman and Jerome M. Schwartzman, *Puttin' on the Blitz: The IRS Attacks a Leveraged Partnership Transaction*, 44 Tax Mgmt. Mem. 115 (2003).

STEPS • The general steps for a leveraged partnership transaction are as follows:

1. The Owner contributes appreciated assets and another partner, the Investor, contributes working capital (or assets) to a newly formed partnership. The Investor, in most circumstances, would eventu-

ally want to acquire those appreciated assets or use those assets in the operation of the partnership's business.

2. The partnership borrows money from a bank.

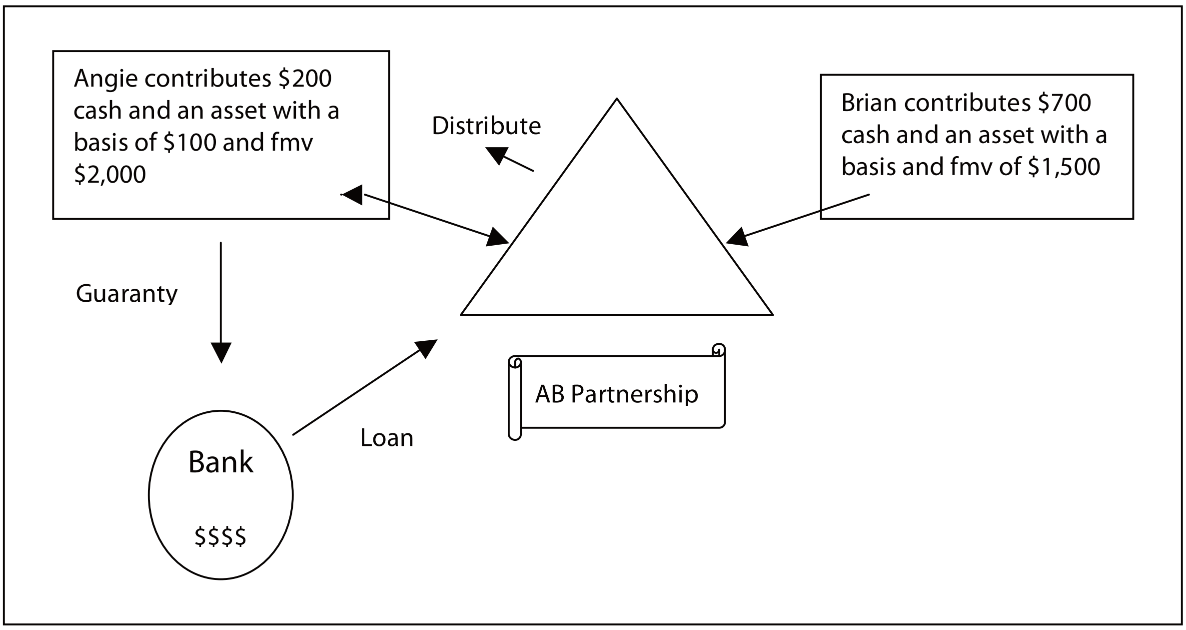
3. The Owner personally guarantees the debt of the partnership, making it a recourse debt as to her. As a result, the Owner's basis in her partnership interest is increased by the amount of the recourse debt.

4. The partnership distributes all or a portion of the loan proceeds to the Owner. The Owner's interest in the partnership is consequently reduced, making the Owner the minority partner of the partnership. Please note that the partnership agreement should contain a mechanism to adjust the percentage interests to account for distributions and/or additional contributions.

5. Assuming that the transaction is properly structured to avoid application of the disguised sale rules, the distribution of all or a portion of the loan proceeds to the Owner should be tax free. If the Owner's basis was not increased by the debt, then the distribution would likely result in taxable gain to the Owner.

6. After seven years, the partnership can distribute the Owner's original assets to the Investor, or different partnership assets to the Owner.

The following diagram illustrates a leverage partnership transaction:



PARTNERSHIP BASICS • When parties join together to form a partnership, they should contribute assets to the partnership that would corroborate the partnership's "business purpose" and support the parties' intent. The parties' intent is a key factor in determining if a partnership was formed. *Comm'r v. Culbertson*, 337 U.S. 733 (1949); *see also ASA Investerings P'ship v. Comm'r*, 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied,* 531 U.S. 871 (2000); *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir.2006). If the partnership is formed as a mere shell, then the IRS may disregard the partnership and treat it as a sham.

Generally, partners recognize no gain or loss on the contribution of assets to the partnership. Similarly, the partnership recognizes no gain or loss from the contribution of property by the partners. §721. The partners will have a basis in their partnership interest equal to the adjusted basis of the assets each contributed. §722. The partnership will have a transferred basis in the assets contributed. §723. A partner is also given basis credit for her allocable share of liabilities of the partnership. If her share of liabilities increases, she is treated as having contributed money to the partnership, and accordingly, her basis in the partnership interest is increased. §752(a); Treas. Reg. §1.752-1(b). If her share of liabilities is decreased, then the partner is treated as having received a cash distribution from the partnership and her basis is decreased by the amount of the deemed distribution. §752(b); Treas. Reg. §1.752-1(c).

There are special rules that are applied when a partner contributes property with a fair market value that differs from its basis. In this situation, there is a disparity between the property's "book" value, or fair market value when contributed to the partnership, and the property's tax basis. This property is called "built-in" gain property, or "704(c)" property (or "built-in loss" property, however, our discussion is focused on "built-in gain" property). The partnership rules require that "income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution." §704(c)(1)(A). The reason for this is to allocate any built-in gain to the partner who contributed the appreciated property to the partnership. The contributing partner could effectively shift the gain from the appreciated property if this was not done. These rules are designed to prevent a partner from shifting the gain to a partner in a lower tax bracket, or to a partner who may benefit from the gain (for example, by offsetting a loss).

There are several methods used to make this allocation, including the traditional method, the traditional method with curative allocations and the remedial allocation method. Generally, when nondepreciable property is contributed to a partnership, the contributing partner will be allocated the tax gain on the property when the partnership disposes of the property. In the case of depreciable property, depreciation deductions may be allocated more heavily to the noncontributing partner to allocate additional income and the corresponding built-in gain to the contributing partner. This is to take into account the difference between the tax and book accounts.

If the contributed property is distributed to a partner other than the contributing partner within seven years of being contributed, then the built-in gain is allocated to the contributing partner under section 704(c)(1)(A). §704(c)(1)(B). Gain (or loss) is recognized and there is a corresponding basis adjustment to the contributing partner's interest in the partnership and to the property distributed to the noncontributing partner. §704(c)(1)(B); Treas. Reg. §1.704-4(e). If other property is distributed to the contributing partner within seven years of the contribution of 704(c) property, other than the property she contributed, then the contributing partner would also have to recognize gain under