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Partnership Disguised Sale Rules May be Changing . . . Again

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The longevity of the most recent rules for the allocation of partnership liabilities and disguised sales is uncertain, but unless the rules are revoked, they restrict certain transactions involving partnerships. This article explains the partnership disguised sale rules—both new and old—focusing on leveraged partnerships and preformation capital expenditures.

On October 5, 2016, Treasury and the IRS issued a comprehensive package of final, temporary, and proposed regulations[1] relating to the allocation of partnership liabilities under section 752 and disguised sales under section 707. The temporary regulations ("the 707 Temporary Regulations") negatively affect ordinary partnership transactions by making many partnership formations and distributions taxable events if the property contributed to or distributed by the partnership is encumbered with debt. In addition, the 707 Temporary Regulations focus on leveraged partnership transactions and thus significantly restrict the ability to withdraw cash from a partnership on a tax-deferred basis in connection with a property contribution. Nonetheless, a welcome ordering rule provided by the 707 Temporary

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[1] T.D. 9787, 81 Fed. Reg. 69291 (Oct. 5, 2016) (final regulations); T.D. 9788, 81 Fed. Reg. 69282 (Oct. 5, 2016) (final and temporary regulations); REG-122855-15, 81 Fed. Reg. 69301 (Oct. 5, 2016) (proposed regulations). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

Regulations clarifies that the debt-financed distribution and preformation capital expenditures exceptions to the disguised sale rules could be applied together to enhance the tax-deferred distribution of cash from a partnership.

As an additional source of uncertainty for taxpayers regarding the allocation of partnership liabilities for disguised sale purposes, on October 4, 2017, Treasury and the IRS issued a report to the president,[2] at the president's request,[3] indicating that Treasury and the IRS are considering whether the 707 Temporary Regulations concerning a partner's share of partnership liabilities for purposes of the disguised sale rules should be revoked and the prior regulations reinstated. The 2017–2018 Priority Guidance Plan, which was released by Treasury and the IRS on October 20, 2017, also includes the proposed removal of the 707 Temporary Regulations. It remains to be seen, however, if or when such a revocation will actually occur and, if so, whether it would be permanent. Accordingly, taxpayers should understand the more restrictive rules as they exist today.

Disguised Sale Rules; Treatment of Liabilities, Generally

In general, the contribution to or distribution by a partnership of encumbered property may trigger a disguised sale if the transfer causes a shift in the allocation of a "nonqualified" liability. In contrast, the contribution or distribution of property subject to a "qualified" liability will generally not cause a disguised sale unless the transaction is otherwise considered a disguised sale.[4]

Generally, qualified liabilities are liabilities incurred more than two years before a property transfer or, for more recent liabilities, liabilities not incurred in anticipation of the property transfer. These "nonanticipatory" liabilities are liabilities entered into in the ordinary course of a trade or business, or in connection with the conduct of a trade or business, if substantially all of the business's assets are transferred; liabilities incurred to acquire or improve the transferred property; and liabilities secured by the transferred property. Any other liability is treated as a nonqualified liability.[5]

Guarantee of Nonqualified Liability No Longer Prevents Disguised Sale

Under the prior regulations, a partner's allocable share of a liability for disguised sale purposes hinged on whether the liability was recourse or nonrecourse.[6] Accordingly, if a partner contributed property subject to a nonqualified liability and continued to bear the economic risk of loss for the liability after the contribution (e.g., by guaranteeing it), the entire liability would be allocated back to the contributing

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[2] Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, 82 Fed. Reg. 48013 (Oct. 16, 2017).

[3] Executive Order 13789, 82 Fed. Reg. 19317 (Apr. 26, 2017).

[4] For example, if the partnership transfers cash to the contributing partner in connection with a property contribution and the cash distribution is treated as disguised sale proceeds, a portion of any qualified liability taken subject to or assumed by the partnership would also be treated as disguised sale proceeds. Section 1.707-5(a)(5).

[5] The legislative history indicates that Congress was particularly concerned about debt incurred in anticipation of a contribution to a partnership where the responsibility for repayment of the loan would be transferred to the other partners. *See* H.R. Rep. No. 432, pt. 2, 98th Cong. 2nd Sess. 1216, 1220-1221 (1984).

[6] Under section 1.752-2(b), a liability is allocated to a partner as a recourse liability to the extent that the partner would be obligated to make a payment in respect of the liability under a hypothetical deemed liquidation test.

partner. As a result, the contributing partner's share of the liability would not have shifted to the noncontributing partners. Thus, the contributing partner would not be treated as having received any proceeds in a disguised sale. Likewise, property distributed to a partner subject to a nonqualified liability would not be considered to be disguised sales proceeds if the liability was recourse to the distributee-partner before the distribution.

The 707 Temporary Regulations generally treat all liabilities as nonrecourse for disguised sale purposes. More specifically, under the 707 Temporary Regulations, if a partner contributes encumbered property to a partnership or receives a distribution of encumbered property from the partnership, that partner's allocable share of the liability is generally equal to that partner's share of the partnership's profits immediately after the transaction in the case of a contribution or immediately before the transaction in the case of a distribution, regardless of whether that partner has guaranteed all or a portion of the debt. Moreover, although partnership profits act as a ceiling in this regard, the contributing or distributee-partner's share of the liability may be further reduced if one or more of the other partners bear the economic risk of loss for the debt. As a result, property contributed to or distributed by a partnership subject to a nonqualified liability, even if fully guaranteed by the contributing or distributee-partner, will generally trigger disguised sale proceeds and, therefore, gain or loss.[7] This fundamental change to the treatment of liabilities for disguised sale purposes generally applies to transactions occurring after January 2, 2017.

Leveraged Partnership Transactions Are More Difficult if All Liabilities Are Treated as Nonrecourse for Disguised Sale Purposes

A significant impact from the treatment of all liabilities as nonrecourse for disguised sale purposes arises in the context of leveraged partnership transactions. Previously, a partner who sought to monetize its interest in property in connection with a contribution of property to a partnership could take advantage of the debt-financed distribution exception to the disguised sale rules.[8] Under this exception, a cash distribution from a partnership to a partner within two years of a property contribution is generally not treated as a disguised sale of the property to the extent that—(1) the distribution is funded with debt, (2) the debt proceeds are traceable to the distribution,[9] (3) the distribution is made within 90 days of the debt being incurred, and (4) the distribution does not exceed the contributing partner's allocable share of the liability.

In a typical leveraged partnership transaction, the contributing partner retains a relatively small interest in the partnership following the property transfer, but guarantees the full amount of the debt. As a result, under the prior regulations, the debt is allocated entirely to the contributing partner as a partnership recourse liability. Thus, under the prior regulations, the subsequent distribution of cash to the

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[7] Section 1.707-5(a)(5)(iii) provides a safe harbor that mitigates nonqualified liability gain recognition, but is limited to situations in which the amount of nonqualified liabilities assumed does not exceed the lesser of 10 percent of the total amount of qualified liabilities assumed or $1 million.

[8] Section 1.707-5(b).

[9] Temporary section 1.163-8T.

contributing partner would not trigger disguised sale proceeds to the extent that the distribution did not exceed the portion of the debt guaranteed by the contributing partner. Under the 707 Temporary Regulations, however, the debt is treated as nonrecourse for disguised sale purposes, notwithstanding that the contributing partner has fully guaranteed the debt or otherwise bears the economic risk of loss with respect to the liability. Accordingly, under the 707 Temporary Regulations, the contributing partner's allocable share of the liability is no more than the typically small percentage interest in partnership profits retained.[10] As a result, unless the 707 Temporary Regulations are revoked and the prior regulations reinstated, a leveraged partnership would appear to no longer be a tax-efficient transaction.

Preformation Capital Expenditures Exception May Play a Larger Role

Because the 707 Temporary Regulations rein in the ability to use the debt-financed distribution exception to withdraw cash from a partnership on a tax-deferred basis in connection with a property contribution, they could cause partners to rely more heavily on the preformation capital expenditures exception.[11]

The preformation capital expenditures exception generally does not treat the transfer of money by a partnership to a partner as disguised sale proceeds to the extent that the transfer is made to reimburse the partner for certain capital expenditures made within two years of the property contribution. So long as the fair market value of the contributed property does not exceed 120 percent of the property's tax basis at the time of the contribution, the contributing partner can be fully reimbursed for the expenditure; otherwise, the reimbursement is limited to 20 percent of the property's then fair market value.

Application of the preformation capital expenditures exception in combination with the debt-financed distribution exception may provide additional relief. The ordering rule provided by the 707 Temporary Regulations[12] clarifies that the debt-financed distribution exception is applied first, enhancing the amount of tax-deferred cash that can be distributed. This is demonstrated by the following example:

> A and B form a partnership ("PRS"). A owns Whiteacre and has made $250 of capital improvements to Whiteacre within the last two years. In A's hands, Whiteacre has a tax basis of $900 and a fair market value of $1,000. A contributes Whiteacre to PRS, and B contributes $500 of cash to PRS.
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> Next, PRS borrows $500 of cash from a third-party bank, all of which is immediately distributed to A. Following the distribution, A and B are equal partners. Under the 707 Temporary Regulations, A's share of the debt for disguised sale purposes is $250 (i.e., 50 percent of the debt based upon A's 50 percent interest in PRS's profits).[13]

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[10] Temporary section 1.707-5T(a)(2).

[11] Section 1.707-4(d).

[12] Section 1.707-5(b)(3).

[13] Temporary section 1.707-5T(a)(2).

Under the favourable ordering rule provided by the 707 Temporary Regulations, the debt-financed distribution exception is applied before the preformation capital expenditures exception. Because all $500 of debt proceeds are traceable under temporary section 1.163-8T to the $500 distribution made to A, the first $250 distributed to A (which is equal to A's allocable share of the liability) would not be treated as disguised sale proceeds under the debt-financed distribution exception. The remaining $250 of distributed debt proceeds would also not be treated as disguised sale proceeds under the preformation capital expenditures exception (i.e., because A is receiving a return of A's qualifying capital expenditures of $250). As a result, the entire distribution would be tax-deferred.

On the other hand, if the preformation capital expenditures exception were to be applied before the debt-financed distribution exception, there was a concern that the amount of the debt proceeds traceable to the distribution would be only $250 (rather than $500), and only $125 of the debt proceeds distributed to A (i.e., $250 of debt traceable to the cash distribution divided by $500 of total debt, multiplied by A's allocable share of the liability of $250) would be excluded under the debt-financed distribution exception. If this reading were correct, it would result in the exclusion of only $375 of the total $500 cash distribution from being treated as disguised sale proceeds.

In conjunction with the 707 Temporary Regulations discussed above, final regulations under section 707 were also issued. Although the 707 Temporary Regulations relating to disguised sales may be revoked under the current administration's initiative to identify and reduce tax regulatory burdens, the final regulations are not addressed in the Treasury report and thus presumably could be retained.

Prior to the issuance of the final regulations, it was unclear whether a contributing partner could be reimbursed for a capital expenditure made by its shareholder, partner, or partnership. The final regulations provide a "step-in-the-shoes" approach in the context of tiered partnerships by treating a partner who acquires property in a section 351, 381(a), 721, or 731 transaction as the original acquirer.

Thus, if a partner purchases property, contributes it to a partnership ("UTP"), and UTP then contributes the *property* to another partnership ("LTP"), the final regulations clarify that UTP can generally be reimbursed by LTP for the expenditure made by UTP's partner.[14] Similarly, if a partner contributes property to a partnership ("LTP"), and then contributes its *interest* in LTP to another partnership ("UTP"), the final regulations clarify that reimbursement for the expenditure is generally permitted from LTP to UTP and from UTP to the contributing partner. Note, however, that if the partner contributed its interest in LTP to a corporation, the corporation would not be eligible for reimbursement from LTP under this exception.[15]

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[14] Section 1.707-4(d)(2), (3). The final regulations take a similar "step-in-the-shoes" approach to qualified liabilities. Thus, UTP's share of any LTP liability would be treated as a qualified liability to the extent that the liability would be qualified had the liability been assumed or taken subject to by UTP in connection with a transfer of all of LTP's property to UTP. Section 1.707-5(e)(2).

[15] Section 1.707-4(d)(3).

Additionally, the final regulations clarify that the preformation capital expenditure exception—

- Applies on a property-by-property basis;
- Includes capital expenditures that the contributing partner elected to deduct, but not deductible expenditures that the contributing partner elected to capitalize; and
- Allows for tax-free reimbursements to be made up to the full cost of an expenditure, without reduction for amortization or depreciation deductions claimed by the contributing partner before the contribution.[16]

New Qualified Liability May Prove Helpful

The prior regulations provided four types of qualified liabilities:

- A liability that was incurred more than two years before the property contribution and that has encumbered the contributed property throughout the two-year period.
- A liability that was not incurred in anticipation of the property contribution, but that was incurred within two years of the property contribution and that has encumbered the contributed property since it was incurred.
- A liability that is allocable under temporary section 1.163-8T to capital expenditures with respect to the contributed property.
- A liability that was incurred in the ordinary course of the contributor's trade or business (e.g., trade payables) as long as all material assets relating to the trade or business are contributed to the partnership.[17]

Operating businesses regularly borrow on a recourse basis and may have no secured debt. In connection with a property contribution or distribution, it has often been difficult to determine whether this unsecured debt constitutes a qualified liability. With respect to the first two categories of qualified liabilities, practitioners often disagreed on what it means for debt to encumber the contributed property. Many take the position that property is encumbered by debt if the creditor has the right to collect against it. The IRS has taken a more restrictive view and requires the debt to be secured by the property in order for it to be treated as encumbered by the debt. The fourth category of qualified liability includes trade payables and other debt incurred in the ordinary course of the contributor's business, but is not helpful for debt incurred outside the ordinary course.

To fill this gap, the final regulations add a fifth qualified liability. This new qualified liability includes a nonanticipatory liability "incurred in connection with" a trade or business where all material assets of the trade or business are contributed to the partnership.[18] When the final regulations were released, it was

[16] Section 1.707-4(d)(1)(ii)(B), -4(d)(5).

[17] Section 1.707-5(a)(6)(i).

[18] Section 1.707-5(a)(6)(i)(E).

unclear what "incurred in connection with" a trade or business meant. Practitioners agreed that it would include debt incurred to purchase extraordinary business items, but questioned whether it would also include debt incurred for other purposes, such as a redemption of shareholders or a distribution to partners made in connection with the partnership's business.

The IRS recently issued Private Letter Ruling 201714028 (April 7, 2017),[19] which is the first private letter ruling to analyze this new qualified liability. The private letter ruling involved an upper-tier partnership ("UTP") that owned an interest in a lower-tier partnership ("LTP"), and contributed its business and related debts to LTP. A portion of the debt assumed by LTP was incurred by UTP to fund a debt-financed distribution to its partners. The distribution was treated as part disguised sale, part distribution. One of the issues addressed in the private letter ruling was whether the portion of the debt funding the distribution (and not the disguised purchase of assets) was "incurred in connection with" UTP's trade or business. The IRS resolved this issue in the taxpayer's favor, finding that this portion of the debt met the definition of the new qualified liability. On its face, the private letter ruling may support a broad reading of the new qualified liability, but any transaction relying on the new qualified liability should be carefully evaluated.

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[19] Written determinations such as private letter rulings represent the IRS's analysis of the law as applied to a taxpayer's specific facts, and these type of written determinations are not intended to be relied on by third parties and may not be cited as precedent. Section 6110(k). They do, however, provide an indication of the IRS's position on the issues addressed.