Passthrough Partner

Disguised Sales Unmasked

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A. Disguised Sale Regulations

On October 5, 2016, the IRS issued final, temporary, and proposed regulations under Sections 707 and 752 of the Internal Revenue Code regarding disguised sales and the allocation of partnership liabilities. The regulations took into consideration voluminous comments from practitioners and experts and included significant changes from the previously proposed regulations issued in early 2014.

In this column, we will explore the flexible tax regime created by Subchapter K and provide context for the promulgation of the disguised sale regulations. We will discuss the importance of partnership liabilities and give a primer on Code Sec. 752 allocations. Finally, we will highlight and examine the new changes to the disguised sale rules and allocation of partnership liabilities under Code Secs. 707 and 752, including examples of some common tax planning transactions that have been foreclosed by the most recent round of regulations.

1. Introduction and Background on Disguised Sale Regulations

Subchapter K was enacted in 1954 with the goal of providing simplicity and flexibility in the formation and unwinding of partnerships in order to encourage investment and foster economic growth. Partners could generally contribute property to a partnership and receive distributions of property from a partnership without gain recognition to the partner or the partnership.

In that regard, Code Sec. 721 generally provides that neither the partner nor the partnership will recognize gain or loss on the contribution of property to a partnership in exchange for a partnership interest therein.[1] Thus, when a partner contributes property to a partnership in his or her capacity as a partner, Code Sec. 721 defers the partner's recognition of any gain or loss on the contributed property. Similarly, Code Sec. 731 generally provides that when a partnership makes a distribution of cash to a partner in his or her capacity as a partner, the partner recognizes gain only to the extent that the cash distribution exceeds the partner's basis in her partnership interest.[2] Thus, when a partner receives a cash distribution, Code Sec. 731 generally defers the partner's recognition of gain until such a time as the partner's basis has been fully recovered. In addition, the distribution of property by a partnership to a partner generally does not result in the partner or the partnership recognizing any gain or loss.[3]

a. History and Purpose of Disguised Sale Regulations

Over time, the flexibility of subchapter K as originally enacted has been significantly eroded as taxpayers have found ways to use the partnership structure to reach advantageous tax outcomes, and Congress has reacted by enacting laws to close down perceived abuses of the partnership form. Examples of the restrictions on flexibility include the disguised sale rules of Code Sec. 707(a)(2)(B), Code Sec. 704(c)(1)(B), Code Sec. 737, Code Sec. 731(c), and Code Sec. 751(b), among others.

The regulations took into consideration voluminous comments from practitioners and experts and included significant changes from the previously proposed regulations issued in early 2014.

As originally enacted, Code Secs. 721 and 731 ensured that property could move freely into and out of partnerships without being currently taxed, and partners could completely recover the basis of their partnership interests prior to any cash distributions being taxed. Those basic principles provided considerable flexibility for transfers of property between partners and partnerships.

That inherent flexibility allowed taxpayers to engage in transactions that were in form a contribution and distribution but in substance were sales. To illustrate this point, consider the following example:

> **Example.** Partner A contributes a property with a value of $360,000 and an adjusted tax basis of $120,000 to the partnership. Shortly thereafter, the partnership distributes $120,000 of cash to the contributing partner. If the form of those transfers were respected, the partner would not recognize any gain on receipt of the cash distribution. If the transfers were recharacterized as a sale, however, the partner would be treated as selling one-third of the property for a taxable gain of $80,000.
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> Even better, if Partner A were willing to receive a distribution of $120,000 in cash and property worth $240,000 from the partnership, if the form of the transfers were respected, she would have succeeded in selling her entire interest in the contributed property without recognizing any taxable gain at the time of the transaction.

To combat perceived abuses such as the ones illustrated in the example above, Code Sec. 707(a)(2)(B), or the so-called disguised sale rules, were issued. Code Sec. 707(a)(2)(B) granted the IRS significant regulatory authority to recharacterize the contributions to, and distributions from, a partnership as part of a disguised sale of property or a partnership interest.[4] The later additions of Code Secs. 704(c)(1)(B)[5] and 737[6] generally established an income tax event when the partners attempted to unwind their partnership within seven years of formation and effectively delayed nonrecognition treatment for many distributions of contributed property for seven years as well.[7]

Under the disguised sale of property regulations, a transfer of property by a partner to a partnership and a transfer of money or other consideration (including the assumption of, or the taking subject to, a liability) by the partnership to the partner constituted a sale of property by the partner to the partnership only if taking into account all the facts and circumstances: (i) the transfer of money or other consideration to the partner would not have been made but for the transfer of property; and (ii) if the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.[8]

The regulations also provide that transfers between a partnership and a partner which are made within two years of each other (regardless of their order) are presumed to be part of a disguised sale.[9] The presumption can only be rebutted by facts and circumstances that clearly establish that the transfers do not constitute a sale.[10] Similarly, when transfers between a partnership and a partner are more than two years apart, the regulations provide that the transfers are not presumed to constitute a sale of property.[11] Likewise, this presumption can only be rebutted by facts and circumstances that clearly establish the transfers constitute a sale.[12]

The legislative history sets forth the following reasons for enacting Code Sec. 707(a)(2)(B):

> In the case of disguised sales, the committee is concerned that taxpayers have deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property

(including money) followed (or preceded) by a related partnership distribution. Although Treasury regulations provide that the substance of the transaction should govern, court decisions have allowed tax-free treatment in cases which are economically indistinguishable from sales of property to a partnership or another partner. The committee believes that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance.[13]

The disguised sale rules were born out of Congress' concerns that taxpayers could use the partnership form to avoid or postpone gain associated with transfers that were purported to be contributions and distributions but were substantively taxable sales. Ultimately, the benefits and flexibility of Code Secs. 721 and 731 were only intended to apply to contributions and distributions undertaken in a partner capacity. The legislative history provides the following:

> In providing these new rules, Congress was mindful that to be considered partners for tax purposes, persons must, among other things, pool their assets and labor for the joint production of profit. To the extent that a partner's profit from a transaction is assured without regard to the success or failure of the joint undertaking, there is not requisite joint profit motive, and the partner is acting as a third party.[14]

If a transfer of property by a partner to the partnership and a transfer of money or other property by the partnership to that partner are deemed a sale (where the partner is treated as engaging in the transfers in a nonpartner capacity), the transfers are treated as a sale of property to the partnership, and Code Secs. 721 and 731 do not apply.[15] Once the components of the disguised sale have been determined, the regulations generally require that those transfers be treated like any other sale or exchange.

b. The Impact of Liabilities, Allocating Liabilities for Purposes of Code Sec. 752, and Allocating Liabilities Under the Superseded Code Secs. 752 and 707 Regulations

Under the disguised sale of property regulations, the treatment of liabilities is generally addressed in two distinct contexts. First, the regulations consider the impact of liabilities that encumber contributed property or that are otherwise assumed by the partnership. Second, the regulations consider the application of the disguised sale rules to distributions that have been funded with debt.

The earlier example illustrates the most straightforward disguised sale, a contribution of money to a partnership followed by a distribution of money or other property from the partnership. A less direct, but equally effective method of extracting equity from contributed property involves the transfer of encumbered property to a partnership. Where in anticipation of transferring property to a partnership the transferor borrows against the property and then transfers the encumbered property to the partnership, retaining the borrowed funds, the transferor has effectively withdrawn his or her equity investment in the property to the extent the burden of repaying the debt is shifted to other partners.

In general, when property is sold subject to a liability or a liability of the seller is otherwise assumed in connection with a sale, the liability is treated as additional consideration paid by the purchaser, increasing the seller's amount realized and taxable gain, if any.[16] In applying this general concept in the context of the disguised sale rules where a partnership has taken property subject to a liability or otherwise assumed a liability of a contributing partner, the question is the extent to which, if at all, that liability should be treated as additional consideration transferred by the partnership to the partner in a disguised sale.

If, in connection with a transfer of property by a partner to a partnership, a partnership assumes or takes property "subject to" a liability that is not a qualified liability,[17] the partnership is generally treated as transferring consideration to the partner from whom the liability is assumed or taken subject to in a taxable sale or exchange to the extent the liability is not allocated to the partner immediately after the transfer. In order to determine whether such an exchange is deemed to occur, it is necessary to determine how such a liability is allocated among the partners.

The Code Sec. 752 regulations provide rules for allocating liabilities among partners. In general, the rules under Code Sec. 752 ensure that all partnership liabilities are allocated among the partners under either the "recourse" or "nonrecourse" liability-sharing rules.[18] For Code Sec. 752 purposes, a recourse liability is defined as a partnership liability to the extent any partner or related person bears the economic risk of loss for that liability.[19] A nonrecourse liability is defined as a partnership liability to the extent that no partner or related person bears the economic risk of loss for that liability.[20]

A recourse liability is allocated to the partner (or person related to the partner) that is treated as bearing the economic risk of loss with respect to the liability. A partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or a related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable, and the partner or related person would not be entitled to reimbursement from another partner or person that is related to another partner.[21]

Upon a constructive liquidation, all of the following events are deemed to occur simultaneously: (i) all of the partnership's liabilities become payable in full; (ii) with the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero; (iii) the partnership disposes of all its property in a fully taxable transaction for no consideration (except for relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership); (iv) all items of income, gain, loss or deduction are allocated among the partners; and (v) the partnership liquidates.[22]

For purposes of determining the extent to which a partner or related person has a payment obligation and bears the economic risk of loss, all statutory and contractual obligations are considered,[23] and it is generally assumed that the partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.[24] Under Reg. §1.752-2(k), however, a recourse payment obligation of a business entity that is disregarded as an entity separate from its owner for federal income tax purposes is taken into account only to the extent of the net value of the disregarded entity as of the allocation date.[25]

For Code Sec. 752 purposes, nonrecourse liabilities of a partnership are allocated to its partners under a three-tier approach. Under this approach, the partnership nonrecourse liabilities are allocated to each partner in the following manner:

(1) First, in an amount equal to the partner's share of partnership minimum gain determined in accordance with the rules of Code Sec.704(b) and the regulations thereunder ("Tier 1");
(2) Second, in an amount equal to the partner's share of taxable gain determined under Code Sec. 704(c) as if the partnership disposed of all partnership property in a taxable transaction subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities for no other consideration ("Tier 2"); and
(3) Any of the partnership's remaining nonrecourse liabilities ("excess nonrecourse liabilities") are allocated to each partner in accordance with the partner's share of partnership profits ("Tier 3").[26]

The Tier 3 rule describes three specific methods of determining a partner's share of profits for these purposes:

(1) The "Significant Item Method"—This method generally permits an allocation to be made in a manner consistent with the allocation of some significant item of partnership income or loss that has substantial economic effect.
(2) The "Alternative Method"—This method generally permits an allocation to be made in a manner deductions attributable to the nonrecourse liability are reasonably expected to be allocated.
(3) The "Additional Method"—This method generally permits an allocation to be made by reference to the manner in which Code Sec. 704(c) built in gain in the property subject to the liability would be allocated to the extent not allocated under Section Tier 2.[27]

Prior to the current changes in the superseded Code Secs. 707 and 752 regulations, for purposes of the disguised sale rules, a nonrecourse liability that was assumed, or taken subject to, was allocated only under Tier 3 and without regard to the Additional Method, and recourse liabilities were allocated in a manner consistent with the approach for allocating recourse liabilities under Code Sec. 752.

2. Key Changes—Final and Temporary Regulations

a. Disguised Sales and Leveraged Distributions—Code Sec. 707[28]

As discussed above, a contribution of property to a partnership in exchange for a partnership interest is generally a tax-deferred transaction. However, if a partner contributes property to a partnership that distributes cash or property to the partner within two years from the date of contribution, the disguised sale rules presume that the transaction was really part of a disguised sale.[29]

One of the exceptions to disguised sale treatment relates to debt-financed distributions.[30] Under the exception, if a contributing partner receives a debt-financed distribution from the partnership, the distribution is subject to recharacterization as part of a sale only to the extent that the distribution exceeds the partner's allocable share of the liability. Specifically, Reg. §1.707-5(b)(1) provides that if a partner transfers property to a partnership and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under Reg. §1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, then the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.[31]

The Treasury believed that often leveraged partnership transactions involved taxpayers entering into noncommercial terms to guarantee debt solely to treat the debt as recourse to the contributor for tax purposes, and thus, allowing the contributor to avoid disguised sale treatment. To illustrate the concern, consider the following example:

> **Example.** A contributes Property A to partnership with a FMV of $500 and an adjusted basis of $125. Within 30 days of the contribution by A, partnership borrows $450 from Bank. A enters into a guarantee with Bank to guarantee partnership's $450 loan. In exchange for his contribution, A receives a 10% interest in partnership and a $450 distribution. B contributes $450 of cash and other property to partnership in exchange for a 90% interest in partnership.
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> Prior to the temporary regulations, A's contribution should not result in a disguised sale based upon the debt-financed distribution exception in Reg. §1.707-5(b)(1). In this scenario, A was able to monetize 90% of the asset he contributed and continues to defer gain.

The new temporary regulations made dramatic changes to the methods for the allocation of partnership liabilities for the purposes of the disguised sale rules. Essentially, the new rules treat all liabilities as nonrecourse, thereby preventing a partner from guaranteeing new or assumed partnership liabilities to avoid a tax event.[32] These changes significantly limit the effectiveness of using leveraged partnership distributions to defer taxable income.

As discussed above, prior to the current changes to the superseded Code Secs. 707 and 752 regulations, for purposes of the disguised sale rules, a nonrecourse liability that was assumed, or taken subject to, was allocated only under Tier 3 and without regard to the Additional Method, and recourse liabilities were allocated in a manner consistent with the approach for allocating recourse liabilities under Code Sec. 752.

Under the new regulations, for purposes of the disguised sale rules, a liability that is assumed (or taken subject to) and is not allocated to another partner as a recourse liability is always treated as a nonrecourse liability and allocated to a partner under Tier 3 without regard to the Significant Item Method, the Alternative Method or the Additional Method.[33] That is, a liability assumed by a partnership in connection with a transfer of property by a partner to a partnership is allocated to the transferring partner, for the purposes of the disguised sale rules, only to the extent the liability is not allocated to another partner as a recourse liability, and then only in proportion to the transferring partner's share of partnership profits.[34] Accordingly, the regulations effectively incorporate a methodology whereby the contributor's share of the liability assumed is the "lesser of" the liability determined under Code Sec. 752 or under Tier 3 without regard to the Significant Item Method, the Alternative Method or the Additional Method. For partnerships that have a single ratio for sharing profits over the life of the partnership, this rule is fairly straightforward to implement. However, for partnerships that do not have "straight up" allocations over the life of the partnership (perhaps preferred interests, fillips, *etc.*), additional guidance is needed regarding reasonable methods for determining a partner's share of profits.

> *The final Code Sec. 707 regulations clarify that you must look to the intent of the transferring partner, rather than the intent of lower-tier partnership, when determining whether a liability is a qualified liability under Reg. §1.707-5(a)(6)(i)(B) or (E).*

The preamble to the regulations makes clear that the decision to require all partnership liabilities to be treated as nonrecourse liabilities and to determine partners' shares of such liabilities based on Tier 3 without regard to the Significant Item Method, the Alternative Method or the Additional Method for disguised sale purposes was to prevent the use of leverage partnership transactions.[35]

The effect of the changes to the regulations can be illustrated with the following examples:

> **Example.** A contributes Property A to partnership with a FMV of $500 and an adjusted basis of $125. Within 30 days of the contribution by A, partnership borrows $450 from Bank. A enters into a guarantee with Bank to guarantee partnership's $450 loan. In exchange for his contribution, A receives a 10% interest in partnership and a $450 distribution. B contributes

$450 of cash and other property to partnership in exchange for a 90% interest in partnership.

Under the superseded regulations, this transaction would not result in a disguised sale. However, under the new regulations, Partner A's guarantee is disregarded for disguised sale purposes and A's share of the $450 liability is determined by applying the same percentage used to determine A's share of excess nonrecourse liabilities under Tier 3 without regard to the Significant Item Method, the Alternative Method or the Additional Method. Accordingly, A's contribution of Property A and receipt of the $450 distribution result in disguised sale proceeds of $405.

Assume the same facts in the previous example except the following: (i) assume that A and B each guarantee the debt 50/50 and (ii) assume that B guarantees 100% of the debt:

Example. Under the first Scenario, A's share of the partnership liability under Code Sec. 752 would be ($225) and A's share of the liability under Tier 3 would be $45. Accordingly, in this Scenario, A would still recognize $405 of disguised sale proceeds. In the scenario where B guarantees 100% of the liability, A's share of the liability for Code Sec. 752 purposes would be $0, and A's share of the liability under Tier 3 would be $45. Accordingly, in this scenario, all $450 of the distribution would be considered disguised sale proceeds based upon the lesser of concept incorporated in the new regulations.

b. Elimination of Bottom Dollar Guarantees—Code Sec. 752[36]

The allocation of partnership liabilities is important because a partner's share of partnership liabilities provides tax basis in the partner's partnership interest. Tax basis is critical to a partner, as it determines the amount of losses from a partnership a partner is able to utilize and the amount of cash distributions a partner may receive without recognizing taxable income as a result of a distribution in excess of basis. The method for allocating partnership liabilities can have a dramatic impact on a partner's tax position. When a partner's share of partnership liabilities increases, it can have the effect of deferring taxable income (by providing additional basis to take losses or receive distributions), while a reduction in a partner's share of partnership liabilities can result in a deemed cash distribution that creates taxable income.

As discussed above, there are two types of debt to allocate: recourse and nonrecourse debt. In general, a partner is allocated a recourse liability to the extent the partner bears the economic risk of loss for such liability. In contrast, nonrecourse liabilities (*i.e.,* liabilities for which no partner bears the economic risk of loss) are generally allocated under the three-tier system previously discussed in this column. In order to increase a partner's share of debt while minimizing the risk that a partner would actually be economically liable to pay on the debt, partners were entering into the so-called bottom dollar guarantees.

To illustrate the mechanics of a typical bottom dollar guarantee, consider the following example:

Example. A partnership has a debt of $2,000,000, and with respect to the debt, a partner enters into a personal guarantee with the lender that requires the partner to pay on the debt only if the lender is unable to collect $200,000. Said differently, once the lender collects $200,000, the partner will have no personal liability under the guarantee. For tax purposes, the partner is considered as guaranteeing only the "bottom" $200,000 of the $2,000,000 debt. Prior to October 5, 2016, in this example, the partner would have received tax basis of $200,000.

Under the old rules, the entire amount of such a guarantee would be allocated to the partner, regardless of whether there was any real risk of such a liquidation event occurring. In effect, partners were able to receive the tax benefits from a theoretical payment obligation, no matter how remote.

The Treasury Department and the IRS believe that bottom dollar guarantees, such as the one illustrated above, should not be recognized as payment obligations because they generally lack significant nontax commercial business purpose. Accordingly, the temporary regulations generally do not recognize "bottom dollar payment obligations" for purposes of determining a partner's share of partnership liabilities under Code Sec. 752.[37] Instead, to the extent a bottom dollar payment obligation exists, the partnership liability is treated as a nonrecourse liability and allocated accordingly.[38]

The term "bottom dollar payment obligation" encapsulates a broad range of what the IRS considered to be noncommercial guarantees and includes:

1) For guarantees—any guarantee other than one in which the guarantor is or would be liable up to the full amount of such guarantor's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied[39];
2) For indemnities—any obligation other than one in which the indemnitor is or would be liable up to the full amount of such indemnitor's payment obligation

if, and to the extent that, any amount of the indemnitee's payment obligation is satisfied[40];

3) For partnership liabilities—any arrangement that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if the arrangement has "a" principal purpose of avoiding having at least one of such liabilities or payment obligations being treated as a bottom dollar payment obligation.[41]

There are a number of exceptions to the general definition of "bottom dollar payment obligation," which explicitly allow certain forms of guarantees to be respected:

1) *De minimis* rule—a limited indemnity between partners is allowed without triggering the bottom dollar payment obligation provision. This exception applies if a partner's payment obligation is not reduced by more than 10% as a result of the arrangement (*e.g.,* partner guarantees all of partnership liability and another partner indemnifies for no more than 10%).[42]
2) Vertical slice rule—partner's payment obligation is a fixed percentage of every dollar.[43] For example, the 2014 proposed regulations blessed a scenario where a partnership borrowed $1,000 and a partner guaranteed 25% of every dollar of the loan. If the bank did not recover $250 of the $1,000 partnership liability, the partner would only be obligated to pay $62.50 (25% of the $250) pursuant to the terms of the guarantee.
3) Limited amount payment obligation—dollar limitation feature does not create a bottom dollar guarantee, in and of itself.[44]

The preamble to the temporary regulations identifies a concern that partners might work together to themselves to create a bottom dollar payment obligation to cause a liability to become a nonrecourse liability.[45] To address this concern, the temporary regulations incorporate an anti-abuse rule that is intended to prevent affirmative use of the general nonrecognition of bottom dollar payment obligations to permit partners, other than those directly or indirectly liable for a partnership liability, to include a portion of a liability in their basis.[46]

The temporary Code Sec. 752 regulations also impose a new disclosure requirement.[47] In that regard, the temporary regulations require a partnership to disclose all bottom dollar payment obligations on Form 8275. Form 8275 should be attached to the partnership's return for the tax year in which the bottom dollar payment obligation is undertaken or modified. The disclosure must identify the payment obligation, including the amount and parties to the obligation, and if a partnership determines a bottom dollar payment obligation meets an exception, the partnership must disclose the facts and circumstances clearly establishing the application of the exception.[48]

There is also a transitional rule in effect for any partner whose allocable share of partnership liabilities under Reg. §1.752-2 exceeds the partner's adjusted basis in the partnership interest on the date the temporary regulations are finalized:

> Under this transitional relief, the partner can continue to apply the existing regulations under § 1.752-2 with respect to a partnership liability for a seven-year period to the extent that the partner's allocable share of partnership liabilities exceeds the partner's adjusted basis in its partnership interest on October 5, 2016. The amount of partnership liabilities subject to transitional relief will be reduced for certain reductions in the amount of liabilities allocated to that partner under the transition rules and, upon the sale of any partnership property, for any tax gain (including Section 704(c) gain) allocated to the partner less that partner's share of amount realized.[49]

These temporary regulations expire on October 4, 2019.[50] However, because the text of the temporary regulations is also incorporated into the text of the new proposed regulations, to the extent the new proposed regulations are finalized, these temporary regulations will become part of the final regulations, which will be effective indefinitely.

i. Changes to Code Sec. 752 Allocations of Recourse Liabilities. In addition, the proposed regulations that were issued in connection with the final and temporary regulations contain an anti-abuse rule. The anti-abuse rule is similar to the anti-abuse rule in the 2014 regulations and will be effective when finalized.

Under existing rules, as discussed above, partners and related persons who have payment obligations are presumed to actually perform those obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.

The proposed regulations are intended to establish that the terms of the payment obligations that are relied upon by taxpayers to meet this test are commercially reasonable and are not designed to solely achieve an allocation of a liability to obtain tax benefits. Accordingly, the facts-and-circumstances focus of the anti-abuse rule provides that a payment obligation may be ignored if a plan to circumvent or ignore the obligation exists.[51]

Under the anti-abuse rule, factors are weighted to determine whether a payment obligation should be respected.

No single factor provides more weight than any other factor. The seven factors include whether:

1. The payment obligation is commercially reasonable.
2. The partner is required to provide commercially reasonable documentation regarding its financial condition.
3. The terms of the payment obligation end prior to the term of the partnership liability.
4. The partnership holds money or liquid assets that exceed reasonably foreseeable needs.
5. Creditors are permitted to promptly pursue payment following default.
6. The terms of the partnership liability would be substantially similar in the absence of the payment obligation.
7. The creditor received executed documents from the partner with respect to the payment obligation within a commercially reasonable period of time after the creation of the obligation.[52]

If a plan to circumvent or avoid the obligation exists or is deemed to exist, the obligation is disregarded and the partnership liability is treated as nonrecourse and allocated accordingly.

c. Changes to Preformation Expenditures/ Qualified Liabilities—Code Sec. 707

Another commonly used exception to the disguised sale rules is the allowance for partners to receive reimbursement of preformation capital expenditures. Preformation capital expenditures for this purpose are costs that a partner has incurred within the two-year period prior to the contribution of the relevant property to the partnership.[53] The purpose of this exception is to permit partnerships to reimburse partners for expenses incurred during partnership formation, as well as for costs associated with the acquisition or improvement of property contributed to the partnership by the partner. In both the old and current regulations, the exception includes a limitation, such that the reimbursement cannot exceed 20% of the fair market value of the relevant property at the time of contribution.[54] This 20% limitation does not apply if the fair market value of the property does not exceed 120% of the property's tax basis.[55]

The rules also permit partnerships to assume certain "qualified liabilities" associated with contributed property without triggering a disguised sale to the contributing partner. Prior to the new rules, qualified liabilities included:

1) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfers the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period[56];
2) A liability that was not incurred in anticipation of the transfer of the property to a partnership but that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred[57];
3) A liability that is allocable under the rules of Reg. §1.163-8T to capital expenditures[58]; or
4) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business.[59]

The new rules contain a number of clarifications and guidance for the application of these exceptions, as well as creating a new category of "qualified liability." The new rules address an open question as to whether preformation capital expenditures were calculated on an aggregate basis, property-by-property basis, or only properties with capital expenditures basis.[60] Under the old rules, the differing methodologies were a gray area that could create dramatically different disguised sale results depending on the circumstances.

i. Final Regulations—New Category of Qualified Liability. In addition to the four existing categories of qualified liabilities described above, the final regulations provide for a new category of qualified liability: a liability that was not incurred in anticipation of the transfer of the property to a partnership but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held, but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business.[61]

In applying the existing categories of liabilities, it has not always been entirely clear what was meant by the term "encumber." Interestingly, this new category of qualified liability does not require that the liability "encumber" the transferred property.

The language of this new category of qualified liability appears rather broad and extensive. A recent IRS letter ruling signaled that the IRS also has a broad view of the new category's scope.[62] In LTR 201714028, a company was planning to transfer cash and all the material operating assets to a partnership in exchange for an interest therein. In connection with the transfer, the partnership would assume certain of the company's liabilities. Some of the liabilities to be assumed included liabilities that were originally used to make distributions in connection with the company's formation, presumably to the company's owners. Subsequently, the liabilities had been refinanced. The remaining liabilities assumed by the company were used to acquire assets, make improvements, pay expenses and otherwise operate the company's business. The facts also indicated that the liabilities were incurred years before the transfer and were not incurred in anticipation of the transfer of the company's assets to partnership.

The IRS ruled that all of the liabilities that were assumed by the partnership in connection with the company's transfer of cash, and all of its material operating assets should be treated as qualified liabilities under this new category of qualified liability.[63] The ruling is significant because it suggests, at least in part, that liabilities that are used to make distributions out of a trade or business can be considered incurred "in connection with a trade or business." That is, under the old rule, a liability could be a qualified liability if incurred in the ordinary course of the contributed business; however, borrowing to fund distributions was typically considered extraordinary borrowings. This ruling suggests that the IRS will consider distributions to an entity's owners to still be liabilities incurred in connection with an entity's trade or business under the right set of facts.

ii. Final Rules—Clarifications on Preformation Capital Expenditures. Under the final rules, preformation capital expenditures funded by a qualified liability are not reimbursable to the extent economic responsibility for the qualified liability is borne by a partner other than the transferring partner.[64]

1) No Double Dip. Prior to the change in the regulations, a question existed as to whether a transferor of property to a partnership was eligible to be reimbursed for capital expenditures under Reg. §1.707-4(d) when those expenditures were funded by a qualified liability and either the economic responsibility for the qualified liability shifted to another partner or the debt was repaid by the transferee partnership (the "double dip" issue). The final Code Sec. 707 regulations provide a limitation to the exception for preformation expenditures, providing that, to the extent capital expenditures are funded by a partner with proceeds of any type of transferred qualified liability, the exception applies only to the extent the reimbursement does not exceed the transferring partner's share of the qualified liability.[65]

2) Step-in-the-Shoes Rule. The final Code Sec. 707 regulations provide a "step-in-the-shoes" rule for the purposes of applying the preformation capital expenditures exception and for determining whether a liability is a qualified liability under Reg. §1.707-5(a)(6) and when a partner acquires property, assumes a liability, or takes property subject to a liability from another person in connection with a nonrecognition transaction under Code Sec. 351, 381(a), 721, or 731.[66]

The final Code Sec. 707 regulations also allow for the application of the "step-in-the-shoes" rule for the purposes of the preformation capital expenditure exception.

3) Tiered Partnerships. Current regulations in Reg. §1.707-5(e) and Reg. §1.707-6(b) provide that if a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the same characterization as either a qualified liability or a nonqualified liability that it had as a liability of the upper-tier partnership.[67] Likewise, if an upper-tier partnership succeeds to a liability of a lower-tier partnership, the liability in the upper-tier partnership retains the same characterization that it had as a liability of the lower-tier partnership.[68]

The final Code Sec. 707 regulations add to the tiered-partnership rules by providing that the debt-financed distribution exception applies in a tiered partnership setting.[69] The upper-tier partnership's share of the lower-tier partnership's liabilities will be treated as direct liabilities of the upper-tier partnership, and the liabilities will be treated as incurred on the same day as the liabilities were incurred by the lower-tier partnership. The final Code Sec. 707 regulations also add that if a partner contributes a lower-tier partnership interest to an upper-tier partnership, a liability of the lower-tier partnership would be a qualified liability to the extent that it would be a qualified liability if the lower-tier partnership had directly contributed its assets and liabilities to the upper-tier partnership.[70]

The final Code Sec. 707 regulations clarify that you must look to the intent of the transferring partner, rather than the intent of lower-tier partnership, when determining whether a liability is a qualified liability under Reg. §1.707-5(a)(6)(i)(B) or (E).[71] Thus, the determination of whether the liability was incurred in anticipation of the transfer of property to the upper-tier partnership is based on whether the partner in the lower-tier partnership anticipated transferring the partner's interest in the lower-tier partnership to the upper-tier partnership at the time the liability was incurred by the lower-tier partnership.[72]

The final Code Sec. 707 regulations also allow for the application of the "step-in-the-shoes" rule for the purposes of the preformation capital expenditure exception. The exception applies when a partner incurs capital expenditures for property, transfers the property to a lower-tier partnership, and then transfers the lower-tier partnership interest to an upper-tier partnership within two years of incurring the capital expenditures. The final Code Sec. 707 regulations provide that in such a scenario, the partner is deemed to have transferred the contributed property to the upper-tier partnership for purposes of the preformation capital expenditure exception, and therefore the partner may be reimbursed by the upper-tier partnership to the same extent the partner could have been reimbursed by the lower-tier partnership.[73]

iii. Final Rules—Clarifications on Qualified Liabilities. Qualified liabilities are generally transferrable from lower-tier partnerships to upper-tier partnerships when a partner transfers its interest in the lower-tier partnership, as long as the liability was not incurred in anticipation of the transfer of property to the partnership (the inquiry hinges on whether the partner anticipated transferring its interest in the lowered-tier partnership to the upper-tier partnership at the time the liability was incurred).

If transfers of money or property between a partnership and a partner are treated in part as a sale or disguised sale, then a portion of the qualified liabilities assumed by the partnership is also treated as consideration received in sale or exchange.

The new regulations provide a *de minimis* exception—qualified liabilities are not treated as disguised sale proceeds if the total amount of all liabilities assumed, other than the qualified liabilities, is the lesser of (A) 10% of the total amount of all qualified liabilities the partnership assumes, or (B) $1 million.[74]

3. Key Changes—Proposed Regulations

a. Removal of "Net Value" Rule in Reg. §1.752-2(k)

The current regulations assume that all partners will meet their payment obligations, regardless of their actual net worth.[75] There is currently an exception to this general principle for partners of disregarded entities. Those partners are presumed to satisfy their payment obligations only to the extent of the net value of the disregarded entity. The newly proposed rule would discard this exception in favor of adopting a new presumption under the anti-abuse rules.

Under the current regulations, disregarded entities do not bear the economic risk of loss with respect to a partnership liability to the extent the liability exceeds the net value of the disregarded entity.

The proposed regulations create a new presumption, for the purposes of the anti-abuse rules, that there is a deemed plan to circumvent or avoid an obligation if there is not a reasonable expectation that a payment obligor would have the ability to make the required payments if they become due and payable.

4. Effective Dates of New Temporary and Final Regulations

The final regulations under Code Sec. 707 apply to any transaction where all transfers occur on or after October 5, 2016.[76] The final regulations under Code Sec. 752 apply to liabilities that are incurred by a partnership, that a partnership takes property subject to, or that are assumed by a partnership on or after October 5, 2016, other than liabilities incurred by a partnership, that a partnership takes property subject to, or that are assumed by a partnership pursuant to a written contract in effect before that date.[77]

The temporary regulations are effective October 5, 2016, and their provisions have various dates of applicability.[78] The proposed regulations will generally be effective when they are published as final regulations, but partnerships and their partners may rely on them before they are finalized.[79] However, the rules in Reg. §1.752-2(k) (regarding the effect of obligations of a disregarded entity on a partner's share of recourse liabilities) still apply to disregarded entities until the proposed regulations are published as final regulations.[80]

President Trump signed an executive order on April 21, 2017, directing the IRS and Treasury Department to examine significant rules that were issued during the final year of the Obama administration and to provide a recommendation as to whether any rules or regulation should be modified or repealed.[81] A high-level IRS attorney recently indicated that the IRS would proceed with the disguised sale rules but did not provide a timetable for when they would be finalized.[82] At this point, there is no indication that these new rules will be on the chopping block once the regulatory review is completed.

[1] Code Sec. 721 (1954).
[2] Code Sec. 731 (1954).
[3] *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 389 (1954).
[4] Code Sec. 707(a)(2)(B) (1984).
[5] Code Sec. 704(c)(1)(B) (1989).
[6] Code Sec. 737 (1992).
[7] When 704(c)(1)(B) and 737 were originally enacted, they imposed a five-year toll. The toll was extended to seven years in 1997. P.L. 105-34, 111 Stat. 788 (1997).
[8] Reg. §1.707-3(b)(1).
[9] Reg. §1.707-3(c)(1).
[10] Reg. §1.707-3(c)(1).
[11] Reg. §1.707-3(d).
[12] Reg. §1.707-3(d).
[13] S. Rpt. No. 169, vol. I, 98th Cong., 2d Sess. 223, 225 (1984).
[14] Staff of Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 223, 226 (Comm. Print 1984).
[15] Reg. §§1.707-3(a)(1) and (2).
[16] Reg. §1.1001-2.
[17] The definition of a qualified liability is discussed later in this column.
[18] Reg. §1.752-1.
[19] Reg. §1.752-1(a)(1).
[20] Reg. §1.752-1(a)(2).
[21] Reg. §1.752-2(b).
[22] Reg. §1.752-2(b)(1).
[23] Reg. §1.752-2(b)(3).
[24] Reg. §1.752-2(b)(6). However, *see Canal Corp.*, 135 TC 199, Dec. 58,298 (2010) for limitations on the payment presumption rule.
[25] Reg. §1.752-2(k).
[26] Reg. §1.752-3(a).
[27] Reg. §1.752-3(a)(3).
[28] The IRS, Section 707 Regarding Disguised Sales, generally, 81 FR 69,291, et seq. (Oct. 5, 2016) (codified at Reg. §1.707-5T).
[29] Reg. §1.707-3(c)(1).
[30] Reg. §1.707-5(a)(5).
[31] Reg. §1.707-5(b)(1).
[32] IRS, Section 707 Regarding Disguised Sales, generally, 81 FR 69,294 (Oct. 5, 2016) (codified at Reg. §1.707-5T(a)(2)(i)).
[33] IRS, Section 707 Regarding Disguised Sales, generally, 81 FR 69,294 (Oct. 5, 2016) (codified at Reg. §1.752(a)(3)).
[34] Reg. §1.752(a)(3).
[35] Reg. §1.752(a)(3).
[36] IRS, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 FR 69,282, et seq. (Oct. 5, 2016) (codified at Reg. §1.752-2T).
[37] Reg. §§1.752-2 and 1.752T (2016).
[38] Reg. §1.752-2T(a)(3)(i).
[39] Reg. §1.752-2T(a)(3)(ii)(C)(1)(i).
[40] Reg. §1.752-2T(a)(3)(ii)(C)(1)(ii).
[41] Reg. §1.752-2T(a)(3)(ii)(C)(1)(iii).
[42] Reg. §1.752-2T(a)(3)(ii)(B).
[43] Reg. §1.752-2T(a)(3)(ii)(C)(2).
[44] Reg. §1.752-2T(a)(3)(ii)(C)(2).
[45] IRS, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 FR at 69,286.
[46] Reg. §1.752-2T(j)(2).
[47] Reg. §1.752-2T(a)(3)(ii)(D).
[48] Reg. §§1.752-2T(a)(3)(ii)(D)(1)-(6).
[49] IRS, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 FR 69,286-7 (codified at Reg. §1.752-2T(j)(3) (2016)).
[50] Reg. §1.752-2T(m) (2016).
[51] Reg. §1.752-2(j)(3).
[52] Reg. §1.752-2(j).
[53] Reg. §1.707-5(6)(B).
[54] Reg. §1.707-4(d)(1)(ii)(B).
[55] Reg. §1.707-4(d)(1)(ii)(B).
[56] Reg. §1.705-5(6)(A) (1992).
[57] Reg. §1.705-5(6)(B) (1992).
[58] Reg. §1.705-5(6)(C) (1992).
[59] Reg. §1.705-5(6)(D) (1992).
[60] Reg. §1.707-4(d)(1)(ii)(B).
[61] Reg. §1.705-5(6)(E) (2016).
[62] LTR 201714028 (Apr. 10, 2017).
[63] LTR 201714028 (Apr. 10, 2017).
[64] Reg. §1.707-4(d)(4)(i).
[65] Reg. §1.707-4(d)(4)(i).
[66] IRS; Section 707 Regarding Disguised Sales, generally, 81 FR 69,294 (Oct. 5, 2016) (codified at Reg. §1.707-4).
[67] Reg. §§1.707-5(e) and 1.707-6(b) (1992).
[68] Reg. §§1.707-5(e) and 1.707-6(b) (1992).
[69] Reg. §1.707-5(b)(1) (2016).
[70] Reg. §1.707-5(e)(2) (2016).
[71] Reg. §1.707-4 (2016).
[72] Reg. §1.705-5T (2016).
[73] Reg. §1.707-4(C)(3) (2016).
[74] Reg. §1.707-4(B)(1) (2016).
[75] Reg. §1.752-2(b)(6); *see* IRS; Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 FR 69,302 (Oct. 5, 2016).
[76] IRS; Section 707 Regarding Disguised Sales, generally, 81 FR 69,296 (Oct. 5, 2016) (codified at Reg. §1.707-9).
[77] IRS, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 FR 69,286 (Oct. 5, 2016) (codified at Reg. §1.752-2T(l)(2)).
[78] The Code Sec. 707 temporary regulations apply to any transaction with respect to which all transfers occur on or after January 3, 2017. The Code Sec. 752 temporary regulations apply to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date. IRS, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 FR 69,286 (Oct. 5, 2016) (codified at Reg. §1.752-2T(l)(2)).
[79] IRS, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 FR 69,305 (Oct. 5, 2016).
[80] IRS, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 FR 69,305 (Oct. 5, 2016).
[81] Exec. Order No. 13,789, 81 FR 19,317 (Apr. 21, 2017).
[82] Matthew R. Madara, *IRS Has No Plans to Halt Frozen Partnership Guidance Projects,* 155 TAX NOTES 742 (May 8, 2017).

