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Tax Alert

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Key Points

- Final, temporary and proposed regulations issued on October 5, 2016, address complex rules dealing with partnership disguised sales and debt allocation rules under Sections 707 and 752 of the Internal Revenue Code.
- Bottom-dollar guarantees used in certain tax-deferred leveraged partnership transactions are no longer effective and all partnership liabilities must be treated effectively as “nonrecourse” for disguised sale purposes.
- Partners and partnerships should carefully evaluate the impact these regulations may have on existing partnership arrangements and future investment structures.

New Partnership Liability and Disguised Sale Regulations

On October 5, 2016, the Treasury Department and the Internal Revenue Service (IRS) issued final, temporary and proposed regulations under Sections 704, 707 and 752 (the “New Regulations”),[1] relating to the partnership disguised sales and debt allocation rules. These New Regulations will have a significant impact on the partnership industry because they limit the ways that certain cash distributions can be made to partners without incurring a current income tax (often in the context of leveraged partnership transactions). The new guidance also eliminates the partners’ ability to use certain guarantees and indemnity arrangements to enhance their tax basis in order to deduct partnership losses or to shelter gain on a contribution of property or a partnership interest where the contributing partner’s share of partnership liabilities exceeds his tax basis in the partnership interest. In the case of publicly traded partnerships (known as “MLPs”), a sponsor’s commonly-employed strategy to monetize appreciated properties on a tax-deferred basis, either upon formation of the MLP or in subsequent dropdown transactions, will be severely restricted by these new rules. Partnerships and partners are advised to consider the impact of these changes made by the New Regulations on existing partnerships, as well as future investment structures.

[1] All “section” references are to sections of the Internal Revenue Code of 1986, as amended.

Background

Previously, on January 30, 2014, the Treasury Department and the IRS issued proposed regulations to address certain perceived deficiencies and technical ambiguities under the then-existing Treasury regulations under the Section 707 disguised sale rules (the “2014 Proposed 707 Regulations”) and to revise the approach of partnership debt allocations under Section 752 (the “2014 Proposed 752 Regulations”). The 2014 Proposed Regulations received significant comments from the tax community, and the New Regulations address these comments for the most part. T.D. 9787 (published as final regulations) generally retains most of the proposed changes from the 2014 Proposed 707 Regulations on disguised sales (the “Final 707 Regulations”) and makes some changes to the rules for allocation of “tier-three” partnership nonrecourse debt under Treasury Regulation §1.752-3 (the “Final 752 Regulations”). These final regulations will apply on or after October 5, 2016.

The IRS withdrew a substantial part of the 2014 Proposed 752 Regulations related to allocation of partnership recourse liabilities and, instead, in T.D. 9788, issued temporary Treasury regulations under both Section 707 (the “Temporary 707 Regulations”) and Section 752 (the “Temporary 752 Regulations”) that will treat all partnership liabilities as, in effect, nonrecourse liabilities in applying the Section 707 disguised sale rules and will eliminate the use of most “bottom-dollar guarantees”[2] in leveraged partnership transactions.

Finally, REG-122855-15 contains proposed Treasury Regulations under Sections 704 (the “Proposed 704 Regulations”) and 752 (the “Proposed 752 Regulations”) that repropose how recourse debt is determined for a partner under Section 752 and whether a deficit restoration obligation (DRO) will be respected under Treas. Reg. §1.704-1 (dealing with allocations under Section 704(b)).

Disguised Sale Rules Under Section 707(a)(2)(B)

Section 707(a)(2)(B) distinguishes between separate contributions of property by the partner to the partnership and the distribution of money or other consideration to the partner by the partnership, on the one hand, and so-called “disguised sales” of property by the partner to the partnership, on the other hand. Generally, a transfer of property by a partner to a partnership followed by a transfer of money or other consideration from the partnership to the partner will be treated as a “disguised sale” of property by the partner to the partnership (and, therefore, the cash or other consideration received may be taxable to the partner) if, based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of property, and, for nonsimultaneous transfers, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership. The regulations under Section 707 provide a number of exceptions to disguised sale treatment and allow cash to be paid by the partnership to the partner without incurring a current income tax. Some of these exceptions are clarified by the Final 707 Regulations, while others will be modified under the Temporary 707 Regulations.

[2] Bottom-dollar guarantees provide creditor protection only if the collateral securing the obligation declines in value to a certain level and is often structured to kick in only if the creditor first exhausts all other remedies available against the partnership.

1. Debt-Financed Distributions

Under the debt-financed distribution exception to disguised sale treatment, a distribution of cash to a partner in connection with a property contribution by such partner is not treated as a taxable sale to the extent that the cash is traceable to a partnership liability (incurred within 90 days of the distribution), and the amount of the distribution does not exceed the partner's allocable share of the liability incurred to fund the distribution. A partner's allocable share of partnership recourse liabilities equals the portion for which the partner (or a related person) bears the economic risk of loss (such as through a partner guarantee). Many leveraged partnerships took advantage of this exception by contributing built-in gain property to the partnership, having the partnership incur debt and distributing the borrowed money to the partner. To the extent that the partner is allocated the debt (e.g., the partner guarantees the partnership debt), such cash was not treated as proceeds from a sale and thus was not currently taxable.

The New Regulations make numerous changes to the application of the debt-financed distribution exception. Most importantly, the Temporary 707 Regulations (effective January 3, 2017) provide that, for purposes of the disguised sale rules, all partnership liabilities (whether recourse or nonrecourse) will be treated, in effect, as nonrecourse liabilities and generally allocable to the transferor partner based on the partner's share of partnership profits. This rule applies for all of the Section 707 disguised sale Regulations and is not limited to the debt-financed distribution exception. Specifically, in the context of the debt-financed distribution exception, this means that a guarantee can no longer be used to treat an otherwise nonrecourse debt as "recourse" to the guarantor partner in order to increase such partner's allocable share of partnership liabilities to shelter debt-financed cash distributions. Further, if another partner guarantees the partnership debt, the partner at issue will not be able to take into account the portion guaranteed by the other partner in determining his share of the debt. The Final 752 Regulations complement this new rule of allocating all partnership liabilities, for Section 707 disguised sale purposes, based on the partner's share of partnership profits method by providing that other methods of allocating the third-tier partnership nonrecourse debt under Treasury Regulations §1.752-3(a)(3) shall not apply.[3] The Final 707 Regulations also adopt the ordering rule in the 2014 Proposed Regulations, which apply the debt-financed distribution exception before other exceptions (discussed below) under the disguised sale regulations.

Additional rules are provided in the Temporary 752 Regulations that, together with the Final 707 Regulations, are designed to curtail leveraged partnerships. Temporary 752 Regulations tweak the bottom-dollar guarantee rule of the 2014 Proposed Regulations (generally not recognizing bottom-dollar guarantees as a payment obligation of a partner), but would allow vertical-slice guarantees and bottom-dollar guarantee arrangements where the taxpayer retains 90 percent or more of the economic risk of loss (EROL) for the liability (that is, up to 10 percent can be indemnified). Subject to certain exceptions, the Temporary 752 Regulations generally treat as "bottom-dollar payment obligations" any obligations other than one in which the partner or related person is, or would be, liable up to the full amount of such

[3] These other methods are referred to as the "significant item method," "alternative method" and "additional method" under Treas. Reg. §1.752-3(a)(3).

partner or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. If a payment obligation is subject to indemnification, reimbursement or contribution, such payment obligation may still be recognized as an obligation if the partner or a related person is liable for, as noted above, at least 90 percent of the partner's or related person's obligation. Another exception, as mentioned earlier, is made for "vertical slice" guarantees—where a partner's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates. The Temporary 752 Regulations will require partnerships to disclose bottom-dollar payment obligations on IRS Form 8275 in the taxable year in which the bottom-dollar payment obligation is undertaken or modified.

These rules regarding bottom-dollar payment obligations in the Temporary 752 Regulations would generally apply on or after October 5, 2016 (subject to a binding contract exception), but allows a seven-year transition period to "transitional partners" whose allocable shares of recourse liabilities exceed their tax basis on October 5, 2016. Such transitional partners may continue to apply the existing Section 752 regulations for seven years, or until their basis is reduced to zero.

These changes relating to the manner in which allocable shares of partnership debt are measured for disguised sale purposes mean that, if a taxpayer engages in a partnership rollup where either partnership assets or interests are transferred to a new partnership, the partners' allocable share of the partnership recourse or nonrecourse liabilities will now be determined using their respective shares of partnership profits without regard to any partner guarantees and thus could potentially trigger a disguised sale. As a result of these changes, partners are very likely to incur taxable gain on a rollup that did not previously exist under the pre-October 5, 2016, regime.

2. Capital Expenditure Reimbursement

Under existing law, when a partner contributes property to the partnership and the partnership reimburses the contributing partner for certain capital expenditures and costs incurred by the partner, cash received by the partner as "reimbursement of capital expenditures" is not taxable. This exception generally applies only to the extent that the reimbursed capital expenditures do not exceed 20 percent of the fair market value of the transferred property (the 20 percent limitation). The 20 percent limitation, however, does not apply if the fair market value of the transferred property does not exceed 120 percent of the partner's adjusted basis in the property at the time of the transfer (the 120 percent test).

The Final 707 Regulations (effective October 5, 2016) clarify a few ambiguities in the existing Regulations. First, the Final 707 Regulations generally provide that the 20 percent limitation and the 120 percent test are to be applied on a property-by-property basis. In addition, the taxpayers are prohibited from "double-dipping" in connection with a capital expenditure reimbursement and also shifting the economics of the borrowing used to fund the capital expenditures to another partner.

3. Tiered Partnerships

The Final 707 Regulations adopt the 2014 Proposed 707 Regulations' approach on tiered partnerships. Under such approach, the debt-financed distribution exception applies in a tiered-partnership setting, and the liabilities attributable to contributed partnership interests are treated as qualified liabilities in the hands of the upper-tier partnership to the extent that the liabilities would have been qualified liabilities had the liabilities been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership. The Final 707 Regulations also clarify that the contributing partner's intent (rather than the lower-tier partnership's intent) is taken into account in determining qualified liabilities status. Lastly, the Final 707 Regulations set forth that a partner "steps in the shoes" of a person (to the extent that the person was not previously reimbursed) with respect to preformation capital expenditures and for determining whether a liability is a qualified liability under Treasury Regulation §1.707-5(a)(6) when a partner acquires the property, assumes a liability or takes property subject to a liability from another person in connection with a nonrecognition transaction described in Sections 351, 381(a), 721 or 731. These rules are effective on October 5, 2016.

Changes to the Debt Allocation Rules Under the Section 752 Regulations

Section 752 generally provides that increases and decreases in a partner's allocable share of the liabilities of a partnership are treated as money contributed (or money distributed) to (or from) the partnership. These liability allocations directly increase or decrease the partner's tax basis in its partnership interest, which, in turn, affects the amount of losses or money that can be allocated or distributed to the partner, thereby directly affecting its tax liability. In the disguised sales area, when a partner transfers encumbered properties to the partnership or if the partnership assumes the partner's liabilities in connection with the transfer of properties, the shifting of so-called "nonqualified liabilities" may be treated as a deemed distribution of cash taxable to the transferor partner even if no other consideration was paid by the partnership to such partner. For this purpose, nonqualified liabilities are generally liabilities that are less than two years old and do not secure the contributed property, have not funded capital expenditures with respect to the contributed property, or are not related to the trade or business of the partnership.

As discussed above, a partner's share of a partnership recourse liability equals the portion of the liability for which the partner or related person bears the EROL. A partner or a related person bears the EROL to the extent that the partner or the related person would be obligated to make a payment if the partnership's assets became worthless and the liability became due and payable. Whether a partner has an obligation to make a payment is determined based on the facts and circumstances at the time of the determination. Under the existing Section 752 regulations, all statutory and contractual obligations relating to the partnership liability (including DROs, guarantees, indemnifications and reimbursement arrangements) are taken into account in determining whether a partner has a payment obligation for a partnership liability, and it is assumed that all partners and related persons will actually satisfy their payment obligations regardless of net worth, unless there exists a plan to circumvent or avoid the obligation.

In determining whether a partner or a related person bears the EROL with respect to a partnership liability, the 2014 Proposed 752 Regulations adopted an all-or-nothing, multifactor test in determining a partner's or a related person's payment obligation (other than bottom-dollar payment obligations) with respect to such partnership liability and imposed a net value requirement on the partner throughout the term of the payment obligation. Such approach received wide criticism from tax practitioners, and the Proposed 752 Regulations drop the net-value requirement and repropose a modified, multifactor test, but incorporate those factors into the general antiabuse section of the regulations as part of the facts-and-circumstances analysis of the payment obligation. Such nonexclusive factors include:

- whether there will be commercially reasonable contractual restrictions that protect the likelihood of repayment of the debt
- whether there is commercially reasonable documentation regarding the partner's financial condition
- whether the payment obligation ends prior to the term of the loan (with some commercial exceptions)
- whether there is an amount of cash or other liquid assets beyond the reasonable needs of the business
- whether the payment obligation does not permit the creditor to promptly pursue payment
- whether the loan terms would have changed absent the guarantee
- whether the creditor benefiting from the obligation did not receive executed loan documents (meaning that the creditor never saw the signed guarantee agreement).

Commentators to the 2014 Proposed 752 Regulations pointed out that the factors listed above may not be satisfied by a DRO (which is also a payment obligation), and they also suggested that, if a DRO is disregarded as an payment obligation of a partner for Section 752 purposes, it should not be given effect for capital account purposes under Section 704. In response to these comments, the Proposed 704 Regulations adopt a separate nonexclusive list of factors in testing for the validity of a DRO and provide that a DRO that is disregarded under the Proposed 704 Regulations will also be disregarded for purposes of the Proposed 752 Regulations. The list of factors in the Proposed 704 Regulations consider:

- whether the partner is subject to commercially reasonable provisions for the enforcement and collection of the obligation
- whether the partner is required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership
- whether the obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account is negative
- whether the terms of the obligation are provided to all the partners in the partnership in a timely manner.

The new proposed regulations provide these nonexclusive lists of factors as evidence of the recourse nature of the debt or the bona fides of a DRO. The failure to include a factor will not be determinative of the status of the debt as recourse to a partner or as a good DRO for the partner, nor is the inclusion of a listed factor determinative of whether the recourse nature of the debt or the DRO will be respected. Thus, the absence of any of the listed factors will not make the debt nonrecourse or cause the DRO to be disregarded as it would have been under the Proposed 2014 Regulations. However, solely for purposes of Section 752, evidence of a plan to circumvent or avoid an obligation is deemed to exist if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable.

These proposed regulations generally do not apply until on or after the date that such regulations are published as final regulations. However, taxpayers can generally rely on them in the interim period before these regulations become final.

These New Regulations have significant impact to existing partnership and partners, as well as future investment transactions involving a partnership.

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