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The IRS Did What to the Partnership Debt Allocation And Disguised Sale Rules?!?

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Abstract: Steven Schneider and Brian O'Connor analyze the major reforms proposed in the new partnership debt allocation and disguised sale rules. Looking at and beyond the disallowance of bottom guarantees, the authors discuss the impact of the full set of changes proposed by the IRS on partnership tax planning.

The afternoon of January 29, 2014, a date three years in the making, was when the bomb was dropped. The IRS[2] proposed sweeping changes to the partnership disguised sale and debt allocation rules by effectively ignoring most partner guarantees and strictly limiting special allocations of partnership nonrecourse debt. Reactions were both instant and harsh. Headlines immediately read ''Practitioners Fuming,''[3] followed by articles titled ''A Guaranteed Debacle''[4] and ''Proposed Regulations on Debt Allocations: Controversial, and Deservedly So.''[5] Just what happened in these regulations that garnered such negative reactions? Surely there are some good parts to the regulations. This article explains in practical terms just what the regulations mean and what is the best path forward.

10,000-FOOT OVERVIEW

The proposed regulations under §707 and §752[6] (the ''Proposed Regulations'') are the IRS's long-time coming response to both perceived abuses[7] and overdue cleanup needed in the disguised sale area.[8] The IRS has a right to tighten the debt allocation rules to enforce the disguised sale statute. The IRS had been arguing for years in tax controversies that the disguised sale rules should apply to various partnerships that received appreciated property from a taxpayer and made an immediate disproportionate debt-financed cash distribution to the same taxpayer. Taxpayers counterargued that the current disguised sale regulations excluded such distributions from tax as long as the debt was allocated to the partner receiving the cash under the Treasury regulations. Taxpayers used various mechanisms to allocate that debt, including partner guarantees[9] and allocations of debt to the partner based on the partner's special preferred return.[10] The IRS appears to be tired of fighting taxpayer interpretations of its regulations in a controversy setting and has now embarked on a rewrite of the underlying fundamental regulatory platform. The rewrite mandates a very narrow approach to defining

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[2] All references to the IRS also include the Department of Treasury Office of Tax Policy, which works closely with the IRS in developing and publishing regulatory guidance.

[3] Elliott, ''Practitioners Fuming After Issuance of New Bottom-Dollar Guarantee Rules,'' 2014 *TNT* 20-1 (Jan. 30, 2014).

[4] Rubin, Whiteway, and Finkelstein, ''A 'Guaranteed' Debacle: Proposed Partnership Liability Regulations,'' 143 *Tax Notes* 219 (Apr. 14, 2014).

[5] Lipton, ''Proposed Regulations on Debt Allocations: Controversial, and Deservedly So,'' *J. Tax'n*, Volume 120, Number 04 (Apr. 2014).

[6] Unless otherwise indicated, references to ''§'' are to sections of the Internal Revenue Code of 1986, as amended, and references to ''Reg. §'' are to sections of the Treasury regulations issued under the Internal Revenue Code.

[7] For a discussion of the IRS concerns on the leveraged partnership disguised-sale transaction see Elliott, ''Panelists Defend Tribune Leveraged Partnership Under Attack by IRS,'' 141 *Tax Notes* 272 (Oct. 21, 2013).

[8] For a detailed description of needed cleanup in the disguised sale rules see Jackel and Walsh, ''Disguised Sales Revisited,'' 114 *Tax Notes* 179 (Jan. 15, 2007) (hereinafter ''Jackel'').

[9] *See Canal Corp. v. Commissioner*, 135 T.C. 199 (2010).

[10] *See* PLR 200436011.

recourse debt and allocating nonrecourse debt — for both disguised sale purposes *and* general §752 basis purposes.

Unfortunately, the IRS is using a sledgehammer to crack a peanut, which leads to more new problems than the IRS was originally trying to solve.[11] In an apparent effort to create more bright lines and limit taxpayer electivity into the recourse debt rules, the Proposed Regulations essentially swing too far in the direction of nonrecourse. Thus, even debt guaranteed by a well-capitalized entity will default as nonrecourse if, for example, the loan document does not require periodic financial documentation from the guarantor, the guarantee doesn't cover the full loan term,[12] *or* the guarantor did not receive ''arm's-length consideration'' for the guarantee. The Proposed Regulations exalt form over substance, and not only do they deny debt allocations from bottom-dollar guarantees, they ignore many other very real guarantees.

The ramifications of the Proposed Regulations extend well beyond disguised sales, implicating partner basis computations and the allocations of partnership deductions.[13] The new requirements arguably make the fundamental rule requiring debt to be allocated based on economic risk elective and create a large trap for the unwary. The effort for new bright-line tests defaulting with nonrecourse treatment effectively allows investors who have nothing at risk to share in tax deductions and debt shares that are essentially paid for by another partner. Indeed, notable commentators have argued that this is exactly what the regulations were supposed to prevent![14]

Although many taxpayers have requested full repeal of the Proposed Regulations, the IRS and Treasury appear steadfast in their quest to finalize the new rules. Therefore, as a practical matter it is important to understand the specific proposals and how they might be improved. In the authors' opinions, the greatest and most fundamental improvement would be to limit most of the changes to rebuttable presumptions that apply only in the disguised sale context. Further, if bottom-dollar guarantees are disallowed across the board, replace that concept with more taxpayer flexibility to allocate third-tier nonrecourse debt to protect negative tax capital accounts. This would achieve the IRS goal of combating disguised sales while preserving the proper economic balance of allocating debt and related deductions to partners who bear the economic risk of loss for those deductions.

PARTNERSHIP DEBT ALLOCATION RULES — JUST WHAT'S GOING ON HERE?

Neither a borrower nor a lender be![15]

It's a good thing Shakespeare wasn't a tax lawyer, as tax planning loves debt. In the partnership setting, it seems everyone wants a share of partnership debt, at least for tax purposes. Debt shares can avoid disguised sales. Debt shares can avoid triggering a negative tax capital account under §731(a).[16] Debt shares can drive ''free'' tax deductions sourced to the debt under §704(b). However, debt is a double-edged sword, as sometimes the partnership doesn't have enough money to pay the debt. That's when Shakespeare's wisdom begins to ring true and taxpayers work to minimize the economic risk associated with that magical debt share.

Nirvana (at least for a tax professional, so it's a low bar) is when a partner receives a share of nonrecourse debt. This type of debt may even make Shakespeare change his tune, as it drives material partner tax benefits and *somebody else* is responsible for paying the

[11] For example, in what is essentially a disguised sale regulation, the expansion to apply the rules for purposes of §752 generally requires the IRS to expand the regulations even further to cover the ramifications under the §704(b) rules and likely the §465 at-risk rules. Further rules may also be needed to stop potential abuse that could result from the new ease with which debt can be categorized as nonrecourse.

[12] It is quite common for a guarantee to be limited to a period before the property ''stabilizes'' and thus is not for the full loan term. It is also common, if a partner leaves the partnership, such as when a majority partner sells to a new majority partner, for the loan guaranty obligation to also transfer to the new partner.

[13] In public forums on the topic, a Treasury official acknowledged that by extending the new limitations to all of §752 and not just §707 disguised sales, the regulations have further ramifications for §704(b) debt-sourced deduction rules that were beyond the initial scope of the Proposed Regulations.

[14] See Rubin et al., note 4 above (discussing how the legislative history mandated that the *Raphan* case was to be overruled and that partnership debt was to be allocated based on ultimate economic risk of loss between the partners overall).

[15] Shakespeare's Hamlet, Act 1, Scene 3.

[16] The term ''tax capital'' describes a partner's equity tax basis, after reducing the partner's outside basis for its share of partnership debt. For example, assume Partners A and B originally contributed $10 each to PRS for a 50% interest and PRS borrowed $80 to buy Building for $100. Partner A begins with $50 of outside tax basis (counting its $40 share of PRS debt), equating to $10 of tax capital (basis not coming from debt). Later, when PRS depreciates Building to $60 but maintains the full $80 of debt, Partner A's $20 share of deductions reduces its outside basis from $50 to $30, and reduces its tax capital from $10 to negative $10. This negative $10 represents the minimum amount of debt Partner A needs to avoid triggering gain under §731(a). For example, if Partner B guaranteed the entire $80 of debt, Partner A would have a deemed debt relief distribution of $40, but because Partner A's outside basis is only $30, Partner A would have a §731(a) taxable gain of $10.

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bank.[17] The other category of debt is recourse, which means there is a real risk that the bank might come knocking on the door. This type of debt is clearly a second choice, but sometimes it's the only way to get the associated tax benefits. In that case, a taxpayer would obviously prefer to guarantee only the least risky portion of the debt. Hence the advent of the so-called bottom-dollar guarantees,[18] where a taxpayer has real risk on the debt, but that risk is triggered only if the property drops below a certain value. For example, if the partnership borrowed $80 to purchase a $100 property, the taxpayer may guarantee the bank that if the property value drops below $20, then the taxpayer will reimburse the bank for that portion of its loss. It is real risk, but with a relatively low likelihood of occurring.

The following narrative breaks down the Proposed Regulations into their component parts, explaining how they diverge from current law, and how they might be improved.

Nonrecourse Debt Allocations

Current Rule

Nonrecourse liabilities are allocated among partners through a series of "tiers" that are designed to (1) first provide partners with needed debt share/basis to align debt share with tax deductions taken (i.e., "tier 1 §704(b) minimum gain"),[19] (2) provide partners with a share of forward or reverse §704(c) gain with sufficient debt share and corresponding basis to protect against taxable gain (i.e., "tier 2 §704(c) minimum gain"),[20] and (3) provide a series of alternative mechanisms to allow partners to share any extra debt basis (i.e., tier 3 excess nonrecourse liability).[21]

The third tier historically provided three elective methods on which to base the partners' allocations of tier 3 debt, allowing partnerships to oscillate between methods from year to year at their choosing:

Category 1. Share of Overall Profits

This is a vague test where profits are determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. This is simple for a 50:50 partnership, but not so clear for a partnership with many tranches in the economic "waterfall" distributions.

Category 2. Share of "Significant Item" of Profits

Taxpayers can specify the partners' interests in profits to the extent reasonably consistent with allocations of some other §704(b)-compliant significant item of partnership income or gain.

Category 3. Share of Debt-Sourced Deductions

The partnership may allocate excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated.

In 2000, the IRS proposed expanding taxpayer flexibility under the third tier. This change continued the theme of allowing taxpayer flexibility in allocating third-tier nonrecourse debt to protect partners from inadvertently recognizing gain from a negative tax capital account.[22] Specifically, the preamble to those 2000 proposed regulations noted that "[t]he partnership liability allocation rules arguably should not accelerate the contributing partner's recognition of that gain when the amount of the partnership's liability attributable to such property is sufficient, if allocated to the contributing partner, to prevent such partner from recognizing gain."[23] The preamble further noted that, as §704(c) built-in gain is depreciated, the Tier 2 debt allocation would decrease, and the contributing partner may not have sufficient debt basis to cover the original negative tax capital account. Therefore, new regulations allowed any §704(c) gain unaccounted for in Tier 2 to first be used in Tier 3 to attract nonrecourse debt. However, this new method (sometimes called "Tier 2.5") was limited to debt secured by the partner's specific §704(c) property.

When the IRS finalized the so-called Tier 2.5 regulations,[24] it drew an important distinction between the debt allocation rules and the disguised sale rules, excluding the benefit of the new flexibility for disguised sale purposes. The disguised sale rules allow Tier 3 allocations of debt to reduce the amount of partner debt relief that could trigger a disguised sale gain, which is logical under an aggregate view of partnerships.[25] However, the preamble to the final regulation noted that the new Tier 2.5, if applicable to disguised sales, would effectively allow taxpayers to avoid more disguised sale gain, the larger the §704(c) built-in gain that they wanted deferred. The preamble noted that such a result was "inappropriate."[26]

Perceived Problems

The root of the problem is, as usual, disguised sales. Because the Tier 3 debt share can avoid a dis-

[17] For a partner with a large equity percentage, this "somebody else" is essentially just the partner's other bank account — but one can pretend that it's like getting something for free.

[18] These are also known simply as "bottom" guarantees or "bottom-up" guarantees.

[19] Reg. §1.752-3(a)(1).

[20] Reg. §1.752-3(a)(2).

[21] Reg. §1.752-3(a)(3).

[22] REG-103831-99 (Jan. 12, 2000).

[23] *Id.*

[24] T.D. 8906 (Oct. 31, 2000).

[25] See Reg. §1.707-5(b)(1) for rules on debt shares taken into account for disguised sale purposes.

[26] *Id.*

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guised sale, the IRS was not enamored with taxpayers' discretion to specially allocate debt under Categories 2 and 3 of the Tier 3 allocation rules discussed above.

TAM 200436011 was an example where the taxpayer tried to avoid disguised sale gain using the flexibility under Tier 3 allocations. The taxpayer contributed appreciated property to a partnership and received a debt-financed distribution (''DFD''). A DFD avoids disguised sale treatment only if the debt is allocable to the partner (either by the partner being at risk for the debt or through a Tier 3 nonrecourse debt allocation). Because taxpayers do not like to be 100% at risk for a debt, the taxpayer chose to specially allocate the nonrecourse debt to the contributing partner in accordance with the significant item of partnership income (Category 2). The IRS challenged this particular transaction on the ground that the preferred return on which the allocation was based was not itself an ''item'' of income, but was instead just a portion of the total overall partnership income.

Proposed Rules

The Proposed Regulations turn off the taxpayer discretion to specially allocate Tier 3 nonrecourse debt pursuant to Category 2 and Category 3 (i.e., no special allocations with a significant item or with related deductions). However, unlike in the 2000 regulations for Tier 2.5, the IRS applied that limitation to disguised sales *and* for regular §752 debt allocation purposes.

Perhaps in a moment of remorse, the IRS created a replacement for Category 2, which we will call the Liquidation Value Option. Under the new Liquidation Value Option, the partnership agreement may specify that the partners' interests in partnership profits, for purposes of Category 1, are equal to their liquidation value percentages. This liquidation value percentage is simply the relative percentage of total equity the partner would receive if the partnership were to liquidate at the time of testing. The liquidation value percentage is tested at the formation of the partnership and upon any further revaluation (bookup) events specified in Reg. §1.704-1(b)(2)(iv)(f)(5) (even if a bookup was not actually done).

Observations

The Proposed Regulations can be viewed as a reasonable attempt at limiting disguised sale planning. However, in what almost seems like an oversight, the Proposed Regulations failed to limit the new anti-abuse rules to the disguised sale context. The application to both disguised sales *and* regular debt allocation rules stands in stark contrast to the approach in the 2000 regulations under Reg. §1.752-3(a)(3) that actually tried to help taxpayers minimize unnecessary non-coverage of negative tax capital accounts. In fact, all of the nonrecourse debt allocation rules are designed to protect taxpayers from inadvertently not having sufficient nonrecourse debt to protect a negative tax capital account.[27] The preamble to the Proposed Regulations (hereinafter the ''Preamble'') did not provide any insight on this particular point, simply saying that Categories 2 and 3 ''may not necessarily reflect the overall economic arrangement of the partners.''

Recourse Debt Allocations — No Bottom Guarantees and a Whole Lot More

Current Rule

A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss (''EROL'').[28] Alternatively, a nonrecourse liability is any liability that is not recourse.[29] This approach of looking at risk of loss, including taking into account partner guarantees as bearing the risk of loss, is a direct congressional mandate.[30]

The current regulations define recourse debt as debt where a partner has EROL. If recourse, the debt is

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[27] Tier 1 is designed to ensure nonrecourse debt and §704(b) minimum gain deductions are matched (ensuring enough basis to take the deductions and avoiding a later recapture of those deductions through insufficient basis to protect the negative tax capital account). Tier 2 is designed to ensure sufficient debt basis to protect a negative tax capital account a partner may have when he or she contributes appreciated property in a non-disguised sale context (such as contributing property subject to a qualified liability with no boot). Finally, Tier 3 was designed to give taxpayers similar flexibility with any excess nonrecourse liabilities.

[28] Reg. §1.752-1(a)(1).

[29] Reg. §1.752-1(a)(2).

[30] Section 79(b) of the Deficit Reduction Act of 1984 directed Treasury to revise and update the §752 regulations to (1) address liability sharing in the context of disagreeing with the result in *Raphan v. United States*, Cl. Ct. 457 (1983), *rev'd on this issue*, 759 F.2d 879 (Fed. Cir. 1985) (which had treated a partnership debt guaranteed by a partner as nonrecourse) and (2) take into account guarantees and indemnities generally. The Conference Report specifically provided that:

> [T]he decision in the Raphan case is not to be followed for purposes of applying section 752 or the regulations thereunder. In addition, the Treasury is to revise and update its regulations under section 752 (as soon as practicable) to take account of current commercial practices and arrangements, such as assumptions, guarantees, indemnities, etc. . . . the conferees intend that the revisions to the section 752 regulations will be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt (other than bona fide nonrecourse debt, as defined by such regulations).

H.R. Rep. No. 432, 98th Cong., 2d Sess. 1235 (1984), at 869.

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then allocated to such partner with EROL. In determining whether a partner has EROL, the regulations apply a constructive liquidation test.[31] They assume the partnership assets are valueless and all debts are due, and determine whether a partner, or a person who is designated a ''related person'' to a partner, would be obligated to make a payment. If a partner has such an obligation, the partner has EROL if that partner is not otherwise entitled to reimbursement from another partner (or a person related to another partner). The regulations go into much more detail, but the general rule is to recognize all legally binding obligations relating to the partnership liability and recognize that liability can be shielded through state-law limited liability protection.[32] Further, they recognize EROL even if it is with respect to only a portion of a liability or limited to a period of time.

Perceived Problems

Ultimately the IRS was troubled by bottom-dollar guarantees that both were tax-motivated and had a relatively low actual risk of loss, finding them not to be commercial transactions. This form of guarantee is popular with real estate partnerships controlled by REITs (so-called UPREITs).[33] The underlying motivation was to fix a shortcoming in the nonrecourse debt regulations that, despite the partnership having significant nonrecourse debt, did not otherwise allocate sufficient debt to protect its negative tax capital. A negative tax capital occurs when a partner contributes appreciated property to an UPREIT, subject to a Reg. §1.707-5 ''qualified liability'' that exceeds the partner's tax basis. The disguised sale rules are designed to protect this situation as tax-deferred. Further, the nonrecourse debt allocation rules are designed by the IRS (yes, the IRS), to further protect contributing partners by providing them sufficient debt share under the nonrecourse debt rules.

Bottom-dollar guarantees exist because the current nonrecourse debt rules do not adequately protect ''good'' contributions of qualified leveraged property. Problems can otherwise occur in the innocent case where the partnership repays the original qualified liability and replaces it with a more general nonrecourse line of credit secured by all partnership properties. In such case, there is often insufficient nonrecourse debt allocable to the contributed property to enable the Tier 2.5 rules to do their job.[34] A similar shortcoming of the Tier 2.5 rules occurs when the §704(c) gain ''burns off'' as the property is being depreciated or amortized. In these unfortunate cases, the taxpayer steps up to the plate and is willing to take on EROL to convert otherwise nonrecourse to recourse debt allocable to such partner. Although these partners are willing to take on risk to fix the nonrecourse debt rule shortcomings, the partners obviously are interested only in taking the minimum risk necessary to protect against the tax gain. That's why bottom-dollar guarantees are limited to the least risky portion of the debt.

Bottom-dollar guarantees became very popular and took on various forms. In an UPREIT context, partners negotiated the ability to make a bottom-dollar guarantee at the time they contribute the property (i.e., while they still have negotiating strength), as they anticipate that their debt shares may eventually run out. Such partners preferred that their guarantees not last indefinitely if they no longer required such risk for basis purposes. The bank, of course, had no real objections to any guarantee that gives them more assets to secure the loan, even if the bank did not originally request such guarantee. As the frequency of bottom-dollar guarantees grew, the IRS began viewing them not as a noble stepping-up-to-the-plate taxpayer solution, but instead as tax-motivated transactions that had little economic risk — hence the Proposed Regulations.

Proposed Rules

The Proposed Regulations targeted bottom-dollar guarantees by disallowing a partner's EROL unless it was a top-dollar guarantee, arguing that anything else was a non-commercial transaction that should not be respected.

After the initial sledgehammer smash to the bottom-dollar guarantee peanut, the Proposed Regulations continued smashing, likely because they also did not like tax-motivated guarantees to avoid disguised sales. Specifically, the Proposed Regulations beefed

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[31] Reg. §1.752-2(b).

[32] Reg. §1.752-2(c).

[33] *See* Cuff, ''Investing in an UPREIT—How the Ordinary Partnership Provisions Get Even More Complicated,'' 102 *J. Tax'n* 1 (Jan. 2005). For the mechanics of a bottom guarantee, see a typical UPREIT ''tax protection agreement,'' which is the document that generally allows the partner contributing appreciated property to make such a guarantee. Complications often arise, for example, when more than one partner is vying to guarantee the least risky portion of the debt.

[34] The mechanics of the nonrecourse debt regulations are that they first break down each debt to property that is securing such liability. Thus if a debt is refinanced and only a small portion of that property is securing the overall debt (along with a lot of other properties), there is much less debt to use when applying the three tiers in Reg. §1.752-3(a). However, Reg. §1.752-3(b) does allow ''any reasonable method'' to allocate a liability among multiple properties securing that liability. Although this flexibility is helpful because the method of allocation cannot change while the liability is outstanding, it is difficult to implement in practice in an UPREIT where properties change and debt share needs change.

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up the anti-abuse rule[35] and set forth a series of "recognition requirements," the failure of any one of which would cause the EROL to be ignored. The full list of recognition requirements follows.

(A) *Net worth requirement/transfer restriction.* The partner or related person is:

(1) Required to maintain a commercially reasonable net worth throughout the term of the payment obligation; or

(2) Subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

(B) *Periodic documentation of financial condition.* The partner or related person is required periodically to provide commercially reasonable documentation regarding the partner's or related person's financial condition.

(C) *Obligated for the full debt term.* The term of the payment obligation does not end prior to the term of the partnership liability.

(D) *No unreasonable excess liquid asset requirements.* The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

(E) *Arm's-length consideration required.* The partner or related person received arm's-length consideration for assuming the payment obligation.

(F) *Top guarantee with no right of indemnification.* In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied (with special rules for indemnity rights).

(G) *Special requirement for indemnity/reimbursement obligations.* In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the indemnitee's or other benefitted party's payment obligation is satisfied.

[35] *See* Prop. Reg. §1.752-2(j).

Luckily, there is a seven-year optional transition period, but even that is complicated. The rule applies to the extent a partner's share of §752 liabilities under the historical rules exceeds its partnership interest basis as of the date the regulations are finalized (i.e., a partner's negative tax capital account as of the effective date of the regulations). However, this grandfathered amount is reduced, for example, by certain gains recognized by the partner over their pro rata share of gains based on their liquidation value percentage.[36] The special grandfather status also terminates if the partnership itself is an entity that undergoes a 50% or greater change in ownership.

Observations

The Proposed Regulations overcompensate for the perceived problem of bottom-dollar guarantees and *Canal*-type[37] disguised sale transactions. If the IRS was simply concerned about negative optics from bottom-dollar guarantees, it could have simply stopped with recognition requirement F above. The remaining recognition requirements are likely aimed at the *Canal*-type DFD transactions. However, by aiming a shotgun at all debt guarantees under §752 and not limiting it to the disguised sale context, the IRS created an almost insurmountable wall of complication and documentation that makes accountants wonder whether they are even able to sign many partnership tax returns.[38] To share the pain, the lawyers are going to be gravely concerned about foot-faults in making sure documentation for non-tax-driven transactions includes all of the bells and whistles the IRS proposes to require for a guarantee to be respected. For example, it is common for certain debt guarantees to go away or be reduced when a property hits stabilization, but that economic provision would mean the debt guarantee is not "recognized," because it does not last for the life of the loan. On top of the sheer implementation pains, it is worth noting that the Proposed Regulations could be viewed as having almost a default rule to ignore partner guarantees absent

[36] As defined in Prop. Reg. §1.752-(3)(a)(3) (essentially the partner's relative share of capital percentage).

[37] *Canal Corp. v. Commissioner*, 135 T.C. 199, 213 (2010). In *Canal* a taxpayer contributed appreciated property to a partnership and received a large DFD. The taxpayer guaranteed the debt, but the court did not respect the guarantee. Many of these recognition requirements likely address this type of fact pattern.

[38] In presenting a draft of this article for a Bloomberg BNA seminar, many accountants in the audience, particularly solo practitioners, simply had no idea how to realistically get the information needed to determine whether these recognition requirements were satisfied. Simply preparing a basic tax return almost required a legal opinion to ensure that the guarantee satisfied all the new regulatory requirements. This is the type of evaluation one might expect in a disguised sale transaction, but not for the types of bank-required partner guarantees that are commonplace.

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someone making sure there are no recognition foot-faults, exactly the *Raphan*[39] problem that Congress told the IRS in 1984 to write regulations to overturn.

Although it is understandable that bottom-dollar guarantees may have a negative appearance, they are merely a symptom of an underlying problem that is not abusive. In fact it is the same problem that the IRS was trying to solve in the 2000 regulations that brought us Tier 2.5. That is, in a non-disguised sale context, a partner can run out of needed nonrecourse debt share even when the partnership has plenty of Tier 3 nonrecourse debt. This occurs in two primary cases. First, the partnership can refinance the debt that was securing contributed §704(c) property, and there is insufficient other partnership nonrecourse debt allocated to the §704(c) property to support the necessary Tier 2.5 allocation to avoid gain. Second, even if there is sufficient secured nonrecourse debt, the original §704(c) gain supporting the Tier 2 or Tier 2.5 allocation ''burns off'' through depreciation or amortization of the underlying property. One solution for the first of these cases is to expand the Tier 2.5 rule to allow any partnership Tier 3 nonrecourse debt to cover a partner's negative tax capital, as opposed to limiting the available debt to the specific nonrecourse liability that is secured by the contributed property.[40] A possible solution to the second problem would be to grandfather a Tier 2.5 allocation even if the §704(c) amount supporting it burns off, much like the rule in the Proposed Regulation that measures a grandfathered negative tax capital account (except without the seven-year limitation).[41]

[39] *Raphan v. United States*, 3 Cl. Ct. 457 (1983), *rev'd*, 759 F.2d 879 (Fed. Cir. 1985).

[40] A similar flexibility arguably already exists in Reg. §1.752-3(b), where a nonrecourse debt secured by multiple properties can be allocated among the properties, using ''any reasonable method.'' Thus, a general line of credit could be specially tracked to the properties that need the debt coverage. The difficulty comes in where the regulations require a one-time allocation of this debt between properties and the rule loses needed flexibility as partners and properties change. Thus we would propose to allow more flexibility in this rule as it applies to Tier 3 debt sharing (essentially allowing the same flexibility that exists in Tier 3 to apply to any nonrecourse debt that is not otherwise accounted for in Tier 1 or Tier 2). We acknowledge that a fixed debt allocation may still be required as it relates to Tier 1 and Tier 2 computations, but the aggregate unused debt could still be allocated among all properties, using the flexibility in Tier 3 (and particularly in Tier 2.5).

[41] An alternative partial fix that exists under current law is to elect the Traditional Method with Curative Allocations under Reg. §1.704-3(c), but limit the ''cure'' to back-end gain from the sale of the specific §704(c) asset. This would at least preserve the §704(c) built-in gain longer with respect to the ''ceiling rule'' amount that would otherwise shift to the non-contributing partner under the Traditional Method, albeit with a potential tax timing cost of more §704(c) gain when the asset is sold.

Recourse Debt Allocations — Net Value Requirement

Current Rule

The current regulations presume that a partner will actually satisfy its guarantee or other EROL, irrespective of the guarantor's net worth, absent facts and circumstances indicating a plan to circumvent or avoid the obligation.[42] This ''presumption-to-pay'' rule is a long-time administrable bright-line rule for determining when a partner has the EROL.

In 2006 the IRS issued regulations to tighten the presumption-to-pay rules to address obligations of disregarded entities sandwiched between the partnership and the tax-regarded partner.[43] For example, assume a regarded partner owns its partnership interest through a disregarded LLC that had only $40 of assets. The disregarded LLC guarantees a full $100 of partnership debt. Should the presumption of an ability to pay $100 partnership debt apply to the regarded partner who is legally at risk only for the assets inside the disregarded LLC? The IRS policed this transaction by adding a special ''net value'' rule that treats the regarded partner as having EROL only to the extent of the net value of the intervening disregarded entity, thus recognizing that the regarded tax partner is legally only at risk for this amount.

The current net value test is less about a problem with the current presumption-to-pay rules and more about simply measuring the legal liability that passes through to the regarded partner. The rule was added not because the presumption-to-pay rule was ineffective generally, but instead because the intervening disregarded entity acted as a liability shield to the extent of the entity's net value. The regarded entity could have had a wealth of assets with a clear ''ability'' to pay, but still not have EROL. Thus, it wasn't a question of the regarded partner having an ability to pay or not; it was a question of whether the legal liability ever passed through to the regarded partner, and the net value test was a mechanism to measure this risk of loss.

Perceived Problems

The IRS was particularly focused on taxpayers using the presumption-to-pay rule to avoid a disguised sale. That's because the disguised sale rules do not treat debt-financed distributions, or DFDs, as part of a disguised sale if the liability is recourse to the partner

[42] Reg. §1.752-2(b)(6) (''it is assumed that all 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'').

[43] T.D. 9289 (Oct. 11, 2006).

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contributing the debt. Thus, the IRS was concerned that the presumption to pay allowed people to avoid disguised sale treatment even when the guarantee was from a poorly capitalized entity.

In a typical DFD transaction, a person holding appreciated property transfers the property to the partnership and receives some equity plus a large debt-financed cash distribution. This transaction is not treated as a disguised sale if the debt is a recourse debt allocated to the partner who received the cash, much as would occur if the partner who owned the asset directly could always borrow against the asset on a tax-deferred basis.[44] Further, a partner could always incur a direct loan tax-free and use the partnership interest as security. However, the DFD structure goes one step further, because the person now primarily responsible for servicing the debt is the partnership, not the partner. Thus, in this context, the transaction can begin to look more like a sale, as shown in the following example.

DFD Example. CorpA has Property with a basis of zero and a value of $100 that it wants to transfer to CorpB for cash. CorpA could sell Property to CorpB for $100 and pay $35 of federal income tax, netting $65.[45] However, if CorpA instead formed a partnership with CorpB, CorpA could contribute Property and Partnership could immediately borrow and distribute $90 cash to Corp A, using tax-free debt-financed distribution. This DFD rule allows CorpA to receive $90 on an after-tax basis instead of the $65 it would receive under a standard sale transaction. All CorpA needs to do is fully guarantee the debt![46]

The government's angst became widely known with the IRS's win (yes, win) in the 2010 *Canal* case.[47] In that case, the Tax Court applied the anti-abuse exception to the presumption-to-pay rule and treated the DFD transaction as a taxable sale. The court cited a number of factors as to why it did not believe the guarantee was real. The court seemed particularly focused on the ability of the guarantor partner to simply clean out its net worth on the eve of the bank asking for payment under the guarantee. The angst became stronger when the IRS similarly attacked a high-profile transaction in CCA 201324013.[48]

Proposed Rules

Pulling out the sledgehammer again, the Proposed Regulations turned off the presumption-to-pay across the board (not just for disguised sales). The IRS then extended the net value test to all partners and related persons, including grantor trusts. Thankfully, the regulations excluded individuals and decedents' estates from this test. After all, how does one measure the future earning power of an individual in a net value test? However, even then the Preamble asks for comments on whether individuals should be included. Without the presumption-to-pay, the Proposed Regulations treat a partner as having EROL only to the extent of the partner's or related person's net value as of the debt allocation date.

The Proposed Regulations also require new proof of net value before EROL can be reflected on the partnership tax return debt allocation. Specifically, the partner must provide information to the partnership as to that person's net value that is appropriately allocable to the partnership's liabilities on a timely basis. The details of proving net value are based on the existing net value rules for disregarded entities discussed above.[49] Those rules mandate that (i) the partner does not count the value of its partnership interest in determining net value; and (ii) the net value is reduced by all other obligations of the partner (other than the particular partnership obligation being tested for EROL).[50]

The presumption-to-pay test is further cut back by excluding liabilities where there is a right to be reimbursed by a non-partner. Currently, EROL excludes liabilities where the partner has the right to seek repayment from another partner (or its affiliate). Thus, if A and B form a 50:50 partnership but A has a deeper pocket, the bank may be satisfied only with a guarantee from partner A. However, if A has a right to seek 50% reimbursement from B, then A bears ultimate EROL for only 50% of the liability. Now assume that, instead of A being reimbursable by B, A takes out insurance so that if A is liable, Insurance Company reimburses A. Thus, although the decision to buy insurance and funding for the insurance likely came solely out of partner A's pocket, it is treated as if A never bore the underlying risk of loss.[51]

Observations

Ouch. The practical implications of this proposal are enormous. While the net value requirement may

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[44] *See* Reg. §1.707-5(b) and Reg. §1.707-5(a)(2)(i).

[45] State and local taxes are assumed to be zero for simplicity — let's all move to Florida!

[46] It is generally a non-starter with the taxpayer when your ingenious tax planning requires them to enter into a full at-risk guarantee from a well-capitalized entity, particularly when the taxpayer does not control the investment decisions with respect to the assets inside the partnership.

[47] *Canal Corp. v. Commissioner*, 135 T.C. 199, 213 (2010).

[48] *See* Lipton, ''Leveraged Partnerships Under Fire? IRS Attacks the Tribune's Transactions,'' 119 *J. Tax'n* 2 (Aug. 2013).

[49] Prop. Reg. §1.752-2(k).

[50] Prop. Reg. §1.752-2(k)(2)(i)(A).

[51] Partner A may ask, ''If I wasn't at risk, why did I have to buy insurance?'' Further, Partner A may ask, ''If, instead, the in-

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make sense in the disregarded entity context, it unfortunately creates havoc when applied more broadly. A more surgical approach would have been to limit the new net value requirement to a rebuttable presumption for disguised sale purposes only. Now, partnerships that have no risk of a disguised sale have huge documentation requirements before the accountant can be comfortable signing a tax return allocating EROL to a partner with a guarantee.

Beyond paperwork, the requirement that net value be computed after first subtracting all other obligations of the guarantor entity effectively treats most guarantors as not having sufficient net value. In reality, a guarantor often has bank-required guarantees in excess of net value when measured in the aggregate.[52] A bank is okay with this because of the remoteness of the possibility that every single guarantee will be called at the same time — much like people trust a well-capitalized insurance company even though insurance companies have total insured losses well exceeding their net aggregate assets. This fact pattern was not a real issue in the original disregarded entity net value regulations, as it is highly unusual for the disregarded special purpose LLC to have any outside guarantees. However, now that the IRS proposes extending this concept across the board, this concept inappropriately disregards very real guarantees by non-individuals.

DISGUISED SALES — UNDERSTANDING MORE

The Proposed Regulations include a number of helpful clarifications to the longstanding disguised sale regulations, addressing many of the questions that have been perplexing taxpayers for years.[53] These changes, primarily mechanical, relate mostly to implementation questions that often do not arise until a taxpayer is trying to fill out his/her tax return. Of course, clarification can often increase the disguised sale gain, such as clarifying that you can't get ''reimbursed'' again for expenditures paid for by qualified liabilities assumed.

Proposed Changes to Debt-Financed Distribution Rules — Reg. §1.707-5(b)

Current Rule

The general disguised sale rule of Reg. §1.707-3 addresses the contribution of property to a partnership followed by a distribution of cash or property that would not have been made ''but for'' the contribution. Subject to presumptions regarding distributions within two years of a contribution, the regulations consider all of the facts and circumstances to determine whether the distribution is properly treated as a sale to the partnership.[54] As noted earlier, Reg. §1.707-5(b), however, provides an important exception to this general rule for debt-financed distributions, or DFDs.

Under the DFD exception, distributions of money to partners are not taken into account for purposes of Reg. §1.707-3 as proceeds of disguised sales to the extent they are traceable to partnership borrowings and the distribution amounts do not exceed the contributing partners' allocable shares of the liabilities incurred to fund them.[55] In other words, if a partner is just getting its share of the debt proceeds, that is not a disguised sale. The regulations also aggregate certain liabilities to address the mechanical complication of when multiple liabilities are used to finance DFDs. Specifically, if partnerships transfer to more than one partner pursuant to a plan all or a portion of the proceeds of one or more liabilities, the DFD exception is applied by treating all of the liabilities incurred pursuant to the plan as one liability.[56] As a result, partners who are allocated shares of the multiple liabilities are treated as being allocated a share of a single liability for purposes of the debt-financed exception instead of being allocated a share of each liability separately.

Perceived Problems

The IRS believes that more guidance is needed on how to apply the rule treating multiple liabilities as a single liability for purposes of the DFD exception. In addition, the IRS believes that taxpayers are uncertain as to whether, for purposes of Reg. §1.707-5(b)(2), they must reduce the amount of money that is deemed to be traceable to partnership liabilities by the amounts that they exclude from disguised sale treat-

surance premiums were put in a savings account to hedge against future risk of loss on the guarantee, would they also be treated as not at risk?'' What is the rationale for this rule? Moreover, what if the insurance company does not actually pay, or if the insurance covers only certain risks but not others, such that the partner can seek insurance reimbursement only if the liability is, for example, due to a flood?

[52] For example, it is common for a real estate developer to have a single well-capitalized entity to serve as the guarantor for bank-required guarantees.

[53] *See* Jackel, note 8 above, and Marich and Hortenstine, ''A Comprehensive Guide to Interpreting and Living With the Rules Governing Disguised Sales of Property,'' 110 *Tax Notes* 1421 (Mar. 27, 2006).

[54] The regulations provided that transfers of property by partners to partnerships followed by transfers of money or other consideration from the partnerships to the partners will be treated as sales of the property transferred by the partners if, based on all the facts and circumstances, the transfers of money or other consideration would not have been made but for the transfers of property and, for nonsimultaneous transfers, the subsequent transfers do not depend on the entrepreneurial risks of the partnerships. Reg. §1.707-3(b)(1).

[55] Reg. §1.707-5(b)(1).

[56] Reg. §1.707-5(b)(2)(ii).

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ment under one or more of the exceptions in Reg. §1.707-4 (for example, because the transfer of money is also properly treated as a reasonable guaranteed payment or a reasonable preferred return).

Proposed Rules

To provide further guidance on the rule treating multiple liabilities as a single liability for purposes of the DFD exception, the Proposed Regulations provide an additional example illustrating how the rule applies.[57] Under the new example, if more than one partner receives all or a portion of the debt proceeds of multiple liabilities that are treated as a single liability under the special rule, the debt proceeds will not be treated as consideration in a disguised sale to the extent of the partner's allocable share of the deemed single liability. Further, to address the interrelation of the DFD exception with other disguised sale exceptions, the Proposed Regulations include an ordering rule that applies the DFD exception first, and then, if there are excess distributions not covered by the DFD exception, these amounts are tested under the remaining exceptions in Reg. §1.707-4.[58] This ordering rule ensures that applying one of the exceptions in Reg. §1.707-4 will not minimize the potential beneficial effect of the DFD exception.

Observations

See, there are parts of the Proposed Regulations that we really like. This is the kick-off of a series of helpful clarifications. Clarifying that the DFD exception applies first is not only important mechanical information tax preparers have been requesting, it also makes the underlying taxpayers happy because it has the effect of maximizing the applicable exemptions.

Proposed Changes to Reimbursement For Preformation Expenditure Exception — Reg. §1.707-4(d)

Current Rule

The general disguised sale rules in Reg. §1.707-3 have a rebuttable presumption that distributions to partners who contributed property within the two prior years are disguised sales. Current Reg. §1.707-4(d), however, provides an exception to the general disguised sale rules for reimbursements of preformation expenditures. Under the current exception, transfers of cash or other consideration by partnerships to partners are not treated as part of disguised sales to the extent that the transfers are made to reimburse partners for capital expenditures that (i) partners incurred during the two-year period preceding their transfers to the partnerships; and (ii) partners incurred with respect to (a) partnership organization and syndication costs or (b) property they contributed to the partnerships, but only to the extent the reimbursed amounts do not exceed 20% of the fair market value of the property at the time of the contributions. In applying the exception, the 20% fair market value limitation does not apply if the fair market value of the contributed property does not exceed 120% of the basis in the contributed property.

Perceived Problems

The IRS is concerned that some taxpayers may be applying the preformation expenditures exception too broadly. The IRS is concerned about, for example, taxpayers aggregating numerous property contributions for purposes of the 20% fair market value limitation described above when separate property contributions would not qualify for the exception if they were analyzed on an asset-by-asset basis.

The IRS also believes that uncertainty exists regarding whether partners may qualify for the preformation expenditures exception in certain cases when they fund their expenditures with borrowed amounts that are transferred to the partnership under the qualified liability exception.[59] Stated differently, there is uncertainty about whether taxpayers can finance their capital expenditures through debt transferred to the partnership and then receive tax-free cash reimbursements again under the preformation expenditure exception. In the view of the IRS, to the extent that partners fund their capital expenditures through borrowings and then shift the economic responsibility for borrowings to other partners, the preformation expenditure exception should not apply.

Finally, the IRS is aware that some uncertainty exists about whether the term ''capital expenditures'' includes only expenditures that are required to be capitalized under the Code and Treasury Regulations. For example, if bonus depreciation is available, is the item no longer an eligible capital expenditure? In light of this uncertainty, the IRS believes that they should provide additional guidance on the definition of the term ''capital expenditures'' for purposes of the preformation expenditure exception.

Proposed Rules

The Proposed Regulations make three significant changes to the reimbursement of preformation expenditure rule in Reg. §1.707-4(d). First, the proposed rules provide that the preformation expenditure ex-

[57] Prop. Reg. §1.707-5(g), *Ex. 12*.

[58] Prop. Reg. §1.707-5(b)(3).

[59] *See* §1.707-5(a)(6) (generally liabilities allocable to capital expenditures, ''old and cold'' liabilities, or other liabilities the regulations deem to be good).

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ception applicable to property contributed by a partner to the partnership must be applied on a property-by-property basis.[60] Second, the Proposed Regulations deny a partner the ability to be reimbursed tax-free for a preformation expenditure if the partner was already effectively reimbursed because (i) they used a qualified liability to make the expenditure; and (ii) they are already benefitting from the qualified liability exception.[61] Finally, the proposed rules address the definition of ''capital expenditures'' by stating that the term has the same meaning as it generally has under the Code and regulations, except that the term includes capital expenditures that taxpayers elect to deduct, and will not include deductible expenses that taxpayers elect to treat as capital expenditures.[62]

Observations

The preformation expenditure exception is very popular among tax practitioners, and any curtailment of the exception will not draw applause from taxpayers. Still, applying the exception on an asset-by-asset approach is not an overreach, provided that the IRS is not unreasonable about how narrowly it defines an asset for purposes of the proposed rule on audit. For example, is an apartment project containing three separate buildings one asset or three assets? If the taxpayer acquired the three buildings as one project in one transaction and otherwise treats the three buildings as one asset, the taxpayer should have the discretion to treat the project as one asset for purposes of the preformation expenditures exception. To apply the rule more narrowly could place a significant compliance burden on taxpayers.[63]

The other two rules are reasonable applications of IRS authority, and tax return preparers will welcome the clarity. The rule denying the reimbursement for preformation expenditure exception for costs effectively already being reimbursed through the qualified liability rule is essentially an anti-abuse rule that is difficult to argue with. Finally, the clarification of the definition of capital expenditures appears to be a reasonable conclusion, and taxpayers should welcome the clarification.

Proposed Changes to Qualified Liability Rules — Reg. §1.707-5(a)(6)

Current Rule

Reg. §1.707-5(a)(5) generally excludes from disguised sale treatment qualified liabilities assumed or taken subject to by partnerships. As discussed above, capital expenditure liabilities qualify as qualified liabilities.[64] Qualified liabilities also include liabilities incurred by partners in the ordinary course of the trade or business in which the property transferred to the partnership was used or held, but only if the partners also transfer all of the material assets in that trade or business to the partnership (''ordinary course liabilities'').[65] For both capital expenditure liabilities and ordinary course liabilities, the liabilities assumed or taken subject to by the partnerships need not actually encumber the transferred property in order to qualify as qualified liabilities.

As to the remaining types of qualified liabilities, they include liabilities incurred more than two years before the transfer and liabilities incurred within two years of the transfer but not in anticipation of the transfer.[66] If contributing partners incurred the liabilities assumed or taken subject to by the partnerships within two years of their contributions, the liabilities are presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish otherwise (or they can qualify for the capital expenditure exception or the ordinary course of business exception).[67] For these two other types of qualified liabilities, the liabilities assumed or taken subject to by the partnership must actually encumber the transferred property.

Perceived Problems

In the Preamble, the IRS expressed a belief that there are some circumstances in which liabilities are falling through the cracks. Currently, only the capital expenditure and ordinary course exceptions allow liabilities that do not actually ''encumber'' contributed assets. However, the IRS believes that there are other good liabilities that may not encumber the properties contributed to partnerships. Specifically, if the contributing partners incurred the liabilities in connection with the conduct of a trade or business, the IRS believes that the liabilities need not encumber the con-

[60] Prop. Reg. §1.707-4(d)(1)(ii)(B).

[61] Specifically Prop. Reg. §1.707-4(d)(2) provides that if (i) the taxpayer funded the capital contribution with a capital expenditure qualified liability defined in Reg. §1.707-5(a)(6)(i)(c); and (ii) the partnership subsequently assumes or takes subject to the liability in connection with the transfer, a transfer of cash or other consideration by the partnership to the partner will not qualify as made to reimburse the partner for the capital contribution to extent that the transfer of cash or other consideration exceeds the partner's share of the liability as determined under Reg. §1.707-5(a)(2).

[62] Prop. Reg. §1.707-4(d)(3).

[63] Ultimately, the appropriate test for what is a separate asset likely depends on the individual facts and circumstances. Because a building may consist of a series of individually capitalized and depreciated sub-assets, simply looking to tax depreciation schedules to define the asset is not practical.

[64] Reg. §1.707-5(a)(5)(i).

[65] Reg. §1.707-5(a)(6)(i)(D).

[66] Reg. §1.707-5(a)(6)(i)(A) and Reg. §1.707-5(a)(6)(i)(B).

[67] Reg. §1.707-5(a)(7).

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tributed property to be qualified liabilities as long as they were not incurred in anticipation of the transfer and the partners transfer to the partnership all assets that are material to that trade or business.

Proposed Rules

The Proposed Regulations add a new category of qualified liability to cover the non-encumbering business liabilities described above. Specifically, the new qualified liability category covers liabilities incurred in connection with the conduct of a trade or business, provided the liabilities were not incurred in anticipation of the transfer and the partners transfer to the partnership all assets that are material to that trade or business.[68] Similar to restrictions under the existing regulations, if partners incurred the liabilities within two years of the asset transfer, (i) the partners are presumed to have incurred the liabilities in anticipation of the transfers unless the facts and circumstances clearly establish otherwise; and (ii) the treatment of the liabilities as qualified liabilities under the new definition must be disclosed under the disclosure rules of Reg. §1.707-8.[69]

Observations

Taxpayers undoubtedly will welcome any expansion of the definition of qualified liabilities, thus reducing potential disguised sale taxes. This change is particularly helpful because taxpayers have always struggled with exactly what ''encumbered'' means and removing that requirement for these trade or business liabilities makes life simpler.

The significance of the proposed expansion, however, is difficult to measure. As discussed above, ordinary course liabilities already qualify as qualified liabilities under the ordinary course exception. As a result, this newly proposed addition addresses only liabilities incurred ''in connection with a trade or business'' that are not in the ''ordinary course of the trade or business.'' Although some liabilities certainly will fall within this expanded definition, it is difficult to predict the reach of the newly proposed addition without some definition of or guidance on ''in connection with a trade or business.'' Nevertheless, taxpayers should view the proposed addition as a positive development in any event. Further, without additional guidance, taxpayers presumably should be able to apply the relatively broad interpretation of ''in connection with a trade or business'' from other contexts.[70]

[68] Prop. Reg. §1.707-5(a)(6)(i)(E).

[69] Prop. Reg. §1.707-5(a)(7).

[70] For example, see §469(c)(6) for the use of that phrase in the passive activity context.

Clarifying the ''Anticipatory Reduction Rule'' — Reg. §1.707-5

Current Rule

To avoid disguised sales, it is important to know a partner's allocable share of a partnership liability — in this case bigger is better. But at what point is a partner's share tested? Under the existing regulations, a partner's share of a liability for purposes of Reg. §1.707-5 will take into account certain reductions in the partner's share of the liability after its transfer to the partnership.[71] For example, partners will take into account subsequent reductions in their shares of a liability if (i) at the time that the partnership incurs, assumes or takes property subject to the liability, it is anticipated that the partner's share of the liability will be subsequently reduced; and (ii) the reduction is part of a plan that has as one of its principal purposes minimizing the extent to which the distribution or assumption of, or taking property subject to, the liability is treated as part of a sale (the ''anticipated reduction rule'').[72]

Perceived Problem

The IRS believes that uncertainty exists as to when a reduction in a partner's share of a liability should be treated as an anticipatory reduction for purposes of Reg. §1.707-5. Indeed, because all liabilities eventually will be repaid or otherwise extinguished, theoretically every liability is anticipated to be reduced. Obviously the regulations intended to target only accelerated pre-planned debt share reductions, but given the vagaries and with so much riding on the answer, further guidance is arguably needed.

Proposed Rules

The Proposed Regulations basically say that if the debt reduction was subject to entrepreneurial risk, that reduction doesn't reduce a partner's debt share. Specifically they adopt an approach that excludes liability share reductions that are subject to the entrepreneurial risks of partnership operations from the types of liability share reductions that could be treated as anticipated reductions.[73] However, the Proposed Regulations also include a rule providing that, if within two years of the partnership incurring, assuming or taking property subject to the liability, a partner's share of the liability is reduced due to a decrease in the partner's or a related person's net value, then the liability reduction will be presumed to be an anticipated reduction, unless the facts and circumstances clearly establish that the decrease in the net value was not antici-

[71] Reg. §1.707-5(a)(3).

[72] *Id.*

[73] Prop. Reg. §1.707-5(a)(3)(i)(B).

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pated.[74] Any such reduction must be disclosed in accordance with Reg. §1.707-8.[75]

Observations

Admittedly, most practitioners didn't lose sleep at night worrying the IRS was going to treat normal debt service payments as an anticipatory debt reduction, particularly because it still has to have as one of its principal purposes the intended avoidance of the disguised sale rules.[76] However, the new clarification is a helpful framework for analyzing other debt reductions and is very welcome guidance.

Tiered Partnerships — Reg. §1.707-5(e) and Reg. §1.707-6(b)

Current Rule

The existing disguised sale regulations address tiered partnership situations only to a limited extent.[77] Under the disguised sale rules for tiered partnerships that do exist, if a lower-tier partnership (''LTP'') succeeds to a liability of an upper-tier partnership (''UTP''), the liability in the LTP retains the character as either a qualified or a non-qualified liability that it had when it was a liability of the UTP. Similarly, if a UTP succeeds to a liability of an LTP, the liability in the UTP retains the same qualified or non-qualified liability character that it had as a liability of the LTP.[78]

Perceived Problem

The IRS believes that insufficient guidance currently exists for taxpayers facing disguised sale issues in tiered partnership settings.

Proposed Rule

The Proposed Regulations add two new helpful tiered partnership rules. First, they clarify that the DFD exception applies in the tiered partnership settings. Mechanically, a UTP's share of LTP liabilities will be treated as direct liabilities of the UTP. They are treated as incurred on the same day as the liabilities were incurred by the LTP.[79] Second, they apply a similar aggregate approach to determine what a qualified liability is when a partner contributes an interest in an LTP to a new partnership. For example, if a partner contributed LTP interest to UTP, a liability of LTP would be a qualified liability to the extent that it would be qualified if LTP had directly contributed its assets and liabilities to UTP. In other words, the partner steps into the shoes of LTP's qualified liability status.[80]

Observations

Keep 'em coming. Tiered partnerships are one of the most underserved fact patterns in IRS guidance, and this was no exception. This welcome aggregate clarification will be particularly comforting for taxpayers, as the difference between a qualified and nonqualified liability can be staggering amounts of tax. The authors welcome continuing IRS guidance in tiered partnerships and, in the meantime, this regulation can provide some modicum of analogous guidance in other, similar situations that are currently unanswered.

Liability Netting — Reg. §1.752-1(f)

Current Rule

In partnership transactions, a partner's share of liabilities can increase and decrease as part of the transaction. For example, if partner A contributes property subject to a $1,000 liability for a 50% interest in a partnership, A is deemed to be relieved of $1,000 of debt and then immediately receive a 50% share of the same debt in its capacity as a partner. Under existing Reg. §1.752-1(f), a partner in this example may net increases and decreases in the partner's share of liabilities resulting from this single transaction in determining whether the partner will recognize gain under §731. Similarly, the regulation permits partners in terminating partnerships and resulting partnerships in partnership mergers or consolidations to net increases and decreases in their shares of partnership liabilities in determining the effect of a partnership merger or consolidation under §752.

Perceived Problem

The IRS believes that netting rules similar to those described above should apply to determining whether disguised sales have taken place in merger and consolidation transactions.

Proposed Rule

The Proposed Regulations extend the principles of Reg. §1.752-1(f) to determine the effect of the merger

[74] Prop. Reg. §1.707-5(a)(3)(ii). This related to the new proposed rule that a partner with a full guarantee is considered to have EROL and a related recourse liability share, only to the extent of the partner's net value (excluded net value already used up with other guarantees).

[75] *Id.*

[76] In the Preamble, the IRS explained that the proposed rule was intended to prevent partnerships that fund regular principal amortization on partnership debts through operations from triggering the anticipated reduction rule. In other words, if partnerships produce profits through their entrepreneurial efforts and then use those profits to reduce their debts, the anticipated reduction rule should not come into play.

[77] *See* Reg. §1.707-5(e) (and Reg. §1.707-6(b) by applying rules similar to Reg. §1.707-5(e)).

[78] Reg. §1.707-5(e).

[79] Prop. Reg. §1.707-5(b)(1).

[80] Prop. Reg. §1.707-5(e)(2).

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or consolidation under the disguised sale rules. Specifically, the Proposed Regulations provide that when two or more partnerships merge or consolidate under §708(b)(2)(A), any increases and decreases in partnership liabilities associated with the merger or consolidation are netted by partners in the terminating partnership and the resulting partnership for purposes of the disguised sale rules.[81]

Observations

Commentators have complained that it currently is not clear whether the liability netting rule of Reg. §1.752-1(f) applies for purposes of the disguised sale rules in merger and consolidation transactions. The Proposed Regulations are a welcome clarification.

Distributions of Leveraged Property — Reg. §1.707-6

Current Rule

The existing regulations under Reg. §1.707-6 apply to disguised sales of property by partnerships to partners. Under those regulations, the rules that apply to disguised sales of property by partnerships to partners mirror the rules for disguised sales of property by partners to partnerships.[82] For example, the regulations under Reg. §1.707-6 currently provide that rules relating to liabilities similar to those in Reg. §1.707-5 apply in determining the extent to which transfers of encumbered property by partnerships to partners will be treated as disguised sales.[83] In addition, the regulations provide that if partners assume or take property subject to liabilities that are not qualified liabilities, the amounts treated as consideration transferred by the partners will equal the amount by which the liabilities assumed or taken subject to by the partners exceeds the partners' share of the liabilities immediately before the transfers.[84]

Perceived Problem

The existing disguised sale exception can be viewed as too generous in certain situations. For example, assume A is a 10% partner in PRS with a net equity value of $100. PRS owns Property with a $1,000 gross value and no debt. In the base case, A would like to receive Property from PRS in redemption of A's interest, plus A would pay $900 to cover the value shortfall. That base case would result in PRS recognizing 90% of its gain in Property. Alternatively, the taxable sale is arguably avoided if PRS first borrowed $900, A guaranteed the loan, and then PRS distributed Property subject to the debt.

At the moment, the IRS believes that it may not be appropriate to take into account a partner's share of a partnership liability immediately before a distribution of appreciated property to the partner when the partner does not have economic exposure for the liability for a meaningful period of time before the partner assumes or takes subject to the liability in connection with the distribution.

Proposed Rule

The Proposed Regulations do not provide a rule addressing the perceived problem described above. Instead, the IRS intends to continue studying the issue. In the meantime, the IRS has requested comments on whether it should amend the current rules under Reg. §1.707-6 to provide that a distributee partner's share of an assumed liability immediately before a distribution is taken into account for purposes of determining the consideration transferred to the partnership only to the extent of the partner's smallest share of the liability within some meaningful period of time (e.g., 12 or more months).

Observations

The IRS is obviously concerned about potentially abusive transactions where a partnership encumbers an appreciated partnership asset with a liability, allocates that liability entirely to a particular partner, and then distributes the asset to the partner without the proceeds of the liability, all within a very short period of time. Under this fact pattern, the partnership potentially can dispose of the appreciated property to the partner for the proceeds of the borrowing without recognizing a gain while the partner effectively avoids economic exposure on the liability until shortly before the partner receives the appreciated property. In some cases, the concern raised by the IRS is a valid concern. However, as with any anti-abuse rule, we are concerned that the IRS will overreach and impact non-abusive transactions in its efforts to prevent perceived abuses under the current regulations.

Perhaps the IRS could limit the anti-abuse rule to cases where the partnership is only transitorily subject to the liability ultimately assumed by the distributee partner, as suggested by the New York State Bar Association report.[85] Alternatively, perhaps the IRS could limit the rule to circumstances in which partnerships have taken steps to shield partners who have not been allocated shares of the liability from the effects of the liability (e.g., cases where the partnership spe-

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[81] Prop. Reg. §1.707-5(f).

[82] Reg. §1.707-6(a).

[83] Reg. §1.707-6(b).

[84] *Id.*

[85] *See* "NYSBA Tax Section: Limit Partnership Nonrecourse Debt to Disguised Sales," 106 *BNA Daily Tax Rpt.* G-2 (June 3, 2014).

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cially allocates the interest expense on a liability to a guaranteeing partner during the time period that the partnership holds the encumbered property).

CONCLUSION

Just what is the end game of the Proposed Regulations? The bottom line is that the basic principles are likely to stay, in some form. In fact, the authors welcome the efforts for general clarity with respect to the mechanics of the §707 regulations. Our hope is, however, that the next draft of the regulations will take into account the myriad public comments on how the bulk of §752 changes should be limited to the disguised sale context. Further, if changes are made to the general §752 debt allocation rules, hopefully this can be done in a surgical manner that materially reduces the procedural complications of the Proposed Regulations and avoids the likely unintended consequences of ignoring many very real partner guarantees in defining recourse debt.

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